The Truth about Day Trading

How to trade your Way to Financial Freedom

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U.S. Government Required Disclaimer - Trading foreign exchange on margin carries a high level of risk, and may not be suitable for all investors. The high degree of leverage can work against you as well as for you. Before deciding to invest in foreign exchange you should carefully consider your investment objectives, level of experience, and risk tolerance. The possibility exists that you could sustain a loss of some or all of your initial investment and therefore you should not invest money that you cannot afford to lose. You should be aware of all the risks associated with foreign exchange trading, and seek advice from an independent financial advisor if you have any doubts.

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Introduction

Your Trading Coach says:

"Today is the first day of the rest of your life."

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The Truth about Day Trading
How to trade your way to financial freedom

What is day trading?

Day trading is simply the buying and selling of any financial instrument in the same trading session. This is different from investing or swing trading. In the former, the instrument, usually a stock or bond, is held for an extended time, sometimes many years. Swing trades extend over days, weeks and sometimes even months.

Day traders seek to capitalise and profit from the many price moves that occur in most instruments every trading session. For example, there have been many days when the Dow Jones Industrial Index has moved by more than 100 points. A move of that magnitude can generate literally millions of dollars in profits for an astute and capable day trader.

Day traders can and do trade everything from stocks to soy beans, currencies to corn and metals to market indices. Your Trading Room coaches trade Commodity Futures and Foreign Exchange currencies. Futures, simply, refer to a contract to buy specific quantities of a commodity or financial instrument at a specified price with delivery set at a specified time in the future. Specifically, they trade market indices around the world and currencies (commonly known as Forex or FX).

Most people believe that investing in property or shares is “safe” and that day trading is only suitable for the mega-rich or criminally insane. But the reality is that trading futures allows for easy entry on short or long positions. Those holding shares in a bear market (a prolonged period in which investment prices fall, accompanied by widespread pessimism) are actually in a much more precarious position. Volume often dries up making selling difficult. That’s why prices fall! Sellers drop their ‘ask’ in order to attract bids from buyers.

Electronically traded futures markets such as the eMini S&P 500 and the DJ EuroSTOXX 50 are among the most liquid in the world. Entering and exiting a position is virtually instantaneous. Forex turnover is an estimated 3 trillion dollars a day. Slippage, where you achieve a lower sale price than asked, is actually very rare.

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Futures contracts allow for highly leveraged positions. Of course, if traded without a logical exit strategy, leveraging can quickly contribute to a trader's demise. However with sensible money management using a strict stop loss strategy, leveraging enables a winning trader to make greater profits with a much smaller risk. *The Truth about Day Trading – How to Trade your Way to Financial Freedom* explores these strategies in depth.

Brokerage for electronically traded futures contracts is a fraction of the cost of trading shares. The world's electronically traded futures markets are available 24 hours a day, five days a week. And the really enticing part is that traders can experience it all from the comfort of their home using a typical home computer.

Risks in Day Trading

When trading shares or property, assuming you are not leveraged, you can only lose your initial investment if you make a poor trading decision and price moves against you. Trading futures, on the other hand, carries with it the risk of losing more than your original investment because you are leveraged 100% of the time.

However, the risk is easily eliminated by setting, and sticking with, a suitable stop loss strategy. This strategy is implemented at the time of entry. It is also essential to stay in contact with your trade. As intraday traders, that should be no problem.

Using these two simple rules, a sound stop loss strategy and monitoring your position, a trader is able to participate in highly liquid and volatile markets with minimal outlay and at no greater risk than trading stocks or property.

What is Leveraging?

Trading futures with leverage positions enables your money to work much more efficiently. You are able to control a large amount of capital for a fraction of the actual cost, effectively using a down payment, or 'margin' to trade. When you sell a long position, or cover a short, you collect or pay the difference between the entry and exit prices without having to outlay the entire contract's value.

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Why is Day Trading a Great Tool to Financial Freedom?

It doesn't matter where you live or what hours you keep, there are markets trading somewhere every minute of every day, five days a week. Readily available internet technology allows virtually anyone to trade on an equal footing with the 'big players'. In fact, the days of large financial institutions 'having an edge' are long gone. You can now see what they see as they see it. You can take the same trades they take. But you have one very big advantage... you're small!

The 'big players' need to buy and sell in large volumes. You don't. Trading just one or two contracts, from the comfort of your own home, can make you money while they're still thinking about it. It's easier than you probably think.

The great thing about using trading as your key to financial freedom is the opportunity it allows you to pursue your hobbies and spend time with family and friends.

At yourtradingroom.com, we start our live coaching sessions with the opening of the Asian FX market. As the sun moves west, we progress to the Frankfurt Exchange where we trade the Eurostoxx50. London is next as the money markets open there. Then we travel across the Atlantic to Chicago where we start trading the S&P.

A day trader's life really is a smorgasbord of opportunities. Full time traders can choose their markets and their times. Part-time traders can choose their markets to fit in with their existing careers. Many traders simply start at 6:00am, trade for two hours, then go and spend time in the garden, play golf or have lunch with friends and then return for another hour or two in the evening.

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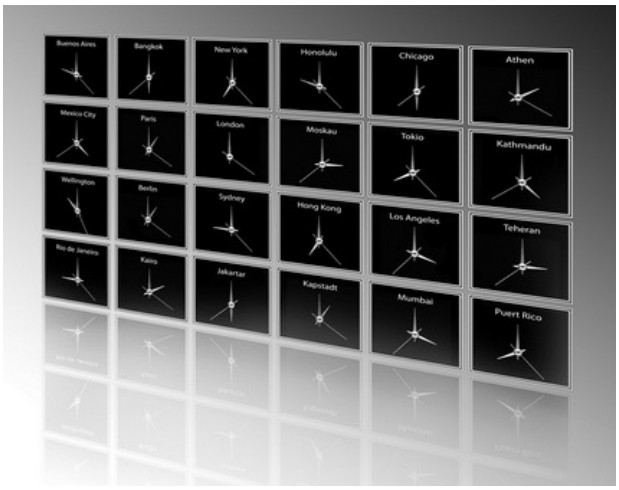

How can you learn to trade?

If you have a broadband internet connection and a computer, you can trade markets anywhere in the world. In fact, you can trade Forex (foreign exchange) any time of day, five days a week! You can learn how to do this in four to six weeks.

In *The Truth about Day Trading – How to Trade your Way to Financial Freedom* we start you on your way to your trading career by giving you an overview of day trading, how it works and how the masters make great money using tools, tips and strategies which we will share with you too.

If you are inspired by what you will learn from this book, you may choose to contact us for more information, or to set you up on the path to your own financial freedom.

Your Trading Room has gone one step further and pairs clients up with their very own trading coach who provides in-depth traders' education and trade signal service in order to give you the best possible chance of succeeding and remaining profitable as a trader.

Remember – success is no accident. It can be learned by anyone, so why not you?

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Chapter One
Futures

Your Trading Coach says:

"If I am to change my results, I am to change my beliefs.

Let go of the outcome; I do not care which way the market moves. The market will do what it does. The biggest risk I will ever take is not betting on myself."

Futures: What Are They?

Definition

A ***futures exchange*** is a central financial exchange where people can trade standardised futures contracts (a contract to buy specific quantities of a commodity or financial instrument at a specified price with delivery set at a specified time in the future.)
The term 'futures' throughout this book refers to ***futures contracts***.

A Brief History

Commodity markets have existed for centuries in all countries where producers and consumers needed a common place to trade their cloth and food staples. Initially, cash was the common form of transaction, but increasingly agreements were made to deliver and pay at some time in the ***future***. These agreements came to be known as ***forward contracts***, and allowed both the seller and the buyer to fix a price in the present which would be acceptable to both parties at such time in the future when the actual delivery of the goods was finalised.
The farmer was therefore able to plant his crop, safe in the knowledge that he was guaranteed a return on his time and monetary investment. The buyer also was safe from the possibility of rising prices due to crop shortages caused by adverse weather conditions, etc. Therefore, there was undeniable benefit to both the buyer and the seller to engage in a forward contract.

Although there are records of these forward agreements dating back to the Japanese silk and rice trade in the seventeenth century, it is generally accepted that similar transactions originated much earlier.

However, most forward contracts weren't honoured by both the buyer and the seller. For instance, if the buyer of corn made an agreement to buy corn, and at the time of delivery the price of corn differed dramatically from the original contract price, either the buyer or the seller would back out. Additionally, the forward contracts market was very illiquid and an exchange was needed that would bring together a market to find potential buyers and sellers of a commodity instead of making people bear the burden of finding a buyer or seller.

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In 1848, the Chicago Board of Trade (CBOT – the world's first modern futures exchange) was formed. Trading was originally in forward contracts; the first contract (on corn) was written on March 13, 1851. In 1865, ***standardised*** futures contracts were introduced.

The benefit of standardised futures contracts is that the contract gives the holder the ***obligation*** to make or take delivery under the terms of the contract. The official price of the futures contract at the end of a day's trading session on the exchange is called the ***settlement price*** for that day of business on the exchange.

The present day futures market retains the basic concept of its agrarian genesis, but has evolved into a far more complex trading vehicle encompassing metals, energy, financial products, and even stock market indices.

How Are They Traded?

Futures are exchange traded derivatives of underlying instruments, and are always traded on an exchange. For example, the value of an emini S&P 500 futures contract will change in response to corresponding values in the S&P 500 stock index. Traditionally futures contracts have been traded on the floor of an exchange by traders representing brokers and institutions, alongside independent traders called 'locals' who are licensed by the exchange to trade their own account. While the open outcry system still exists in many exchanges around the world, there is an increasing movement toward electronic matching of trades. Exchanges such as Eurex in Frankfurt, Germany, are totally electronic, with market participants finalising transactions in milliseconds on their personal computers which are linked to the exchange servers (through their brokers) via the internet.

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Futures contracts are highly standardised, usually by including specifications such as:

- The underlying asset or instrument. This could be anything from a barrel of crude oil to a short term interest rate.
- The type of settlement, either cash settlement or physical settlement.
- The amount and units of the underlying asset per contract. This can be the units of foreign currency, etc.
- The currency in which the futures contract is quoted.
- The delivery date.
- The last trading date.

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Market Participants

Hedgers (individuals and firms that make purchases and sales in the futures market) operate with the attempt to secure the future price of a commodity, which is intended to be sold at a later date in the cash market. By taking a futures position that is approximately equal and opposite to a position the hedger has in the cash market, he or she can offset any adverse effects that weather conditions, economic downturns, war or social upheaval may have on their initial position. A pig farmer for example, may *short sell* (the selling of a stock that the seller doesn't own) pork belly futures to offset the possibility of a fall in anticipated price come market time, while at the same time, a meat processor may *buy* contracts to insure against a possible future price surge. Similarly, a retirement fund manager who is nervous about impending economic news may short sell DJ EuroSTOXX 50 or DAX futures to offset a stock position he holds in various European exchanges, rather than sell his stock holdings and pay the considerable transaction costs of doing so. If the news is bad and stock prices fall, he will have protected his position by profiting with the corresponding fall in the futures market.

Speculators (a person who trades derivatives, commodities, bonds, equities or currencies with a higher-than-average risk in return for a higher-than-average profit potential).are often blamed for many of the problems that afflict most western economies. With very few exceptions (George Soros, who nearly broke the back of the Bank of England with his currency dealings, and Nick Leeson, whose speculative trading in Singapore caused the collapse of Barings Bank are two) these accusations are without foundation.

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Futures markets are very large and complex mechanisms whose workings are largely a mystery to the vast majority of the population.

Speculation is the assumption of the risk of loss, in return for the uncertain possibility of a reward. It involves the buying, holding, selling, and short-selling of stocks, bonds, commodities, currencies, collectibles, real estate, derivatives, or any valuable financial instrument to profit from fluctuations in its price, as opposed to buying it for use or for income via methods such as dividends or interest.

Far from being the source of ill tidings for markets, speculators perform two indispensable tasks: by investing their own capital into the market they provide liquidity, and thus allow prices to increase in an orderly manner, preventing wild fluctuations when large orders are filled. They also facilitate a levelling of the supply and demand process in cases of shortages and surplus. If a commodity is in short supply, speculative buyers will come in to the market causing prices to rise. This, in turn, puts the breaks on consumption, thereby extending the market life of the goods. Similarly, if a product is over supplied, short sellers will enter the market, effectively driving down prices to a level that makes the commodity attractive enough for buyers to snap up a bargain, thus increasing demand.

As Todd Lofton remarks in his book *Getting Started In Futures*, 'A futures market without speculators would be like a country auction without bidders – and would work just as well.'

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Leveraging & Margins

Margin

In the futures market, leverage refers to the ability to control large cash positions with a relatively small capital base. To enter a futures position, a trader need only deposit a fraction of the commodity's cash value into a margin account with his or her broker. A margin for futures is not a down payment for the commodity, as it can be when investing in shares. A margin deposit carries no rights or ownership, and is simply a security bond to protect the financial security of the marketplace (and your broker to a certain degree). There are basically two types of margin: an initial margin, and a maintenance margin.

An ***initial margin*** is the deposit required to *initiate* either a short (the sale of a borrowed security, commodity or currency with the expectation that the asset will fall in value) or long (the buying of a security such as a stock, commodity or currency, with the expectation that the asset will rise in value) position in a futures contract. It is a security deposit to ensure that traders have sufficient funds to meet any potential loss from a trade. A ***maintenance margin*** is the amount of initial margin that must be maintained for that position before a margin call is generated. Note that a maintenance margin level is NOT in addition to the initial margin.

For example, let's assume that the initial margin required to buy or sell a particular commodity contract is $1,200 and the maintenance margin requirement is $800. Should losses on open positions reduce the funds in your trading account to $750, you would receive a margin call for the $450 needed to restore your account back to the initial $1,200. If the margin call was not answered and the account balance was not immediately restored to the initial margin requirement, the broker would liquidate your position in order to cover the difference.

Leverage

Trading futures with leveraged positions enables your money to work much more efficiently. You are able to control a large amount of capital for a fraction of the actual cost, effectively using the deposited margin to trade. When you sell a long position, or cover a short, you collect or pay the difference between the entry and exit prices without having to outlay the entire contract's value.

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For example, let's assume Trader A is a stock trader with US$5,000 to invest. He decides to buy 1,000 XYZ shares at $5.00. Let's also assume he's made the correct decision and the share price rises 1% to $5.05. He sells for a total of $5,050 realising a profit of exactly $50.00 or 1% of his original investment.

Trader B is a futures trader with a similar US$5,000 to invest. She's able to buy five $5 mini-Dow contracts using $1,000 per contract margin. Again assume she's made the correct decision and the market moves 1% in her favour from 12,000 points to 12,120 points – a difference of 120 points at $5 per point, per contract. The result? Well, 120 points multiplied by $5 equals $600. Multiply that by her five contracts and you'll see she's realised a total gain of $3,000 or 60% Return On Investment.

Of course, leverage is a double-edged sword. While gains can be magnified by utilising the power of leverage, so too can losses. That is why futures markets should only be traded using 'risk capital', and not borrowed money or cash which has been put aside to fund life essentials. Margin requirements mean that a trader is essentially already using 'borrowed' capital.

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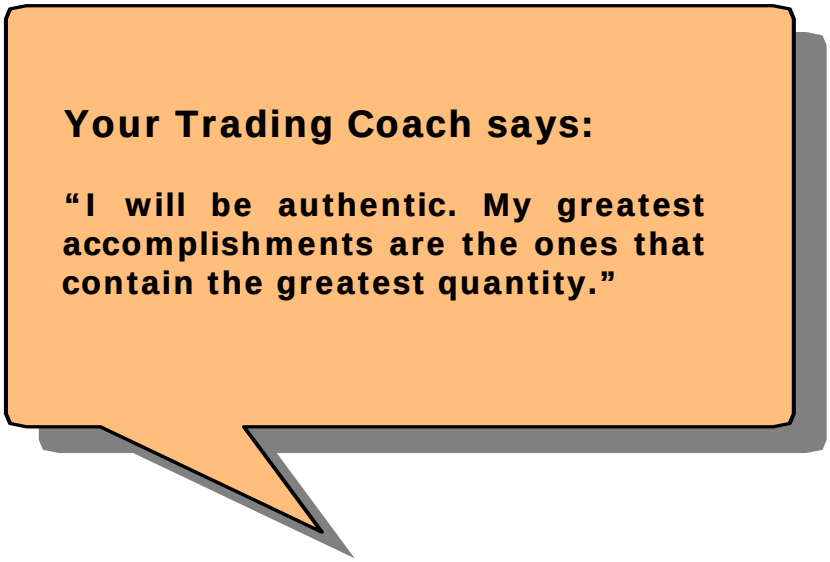
Chapter Two
Introduction to Forex


Your Trading Coach says:
“I will be authentic. My greatest accomplishments are the ones that contain the greatest quantity.”

Introduction to Foreign Exchange

Definition

Foreign exchange is the value of one currency stated in terms of another currency.

A person who exchanges one country's money for currency issued by another country has acquired foreign exchange.

The foreign exchange (also known as the currency, forex or FX) market exists wherever one currency is traded for another. It is the largest and most liquid financial market in the world and includes trading between large banks, central banks, currency speculators, multinational corporations, governments, and other financial markets and institutions. The average daily trade in the Global Forex and related markets is currently almost US$ 4 trillion.

Market Size and Liquidity

The FX market has been referred to as the market closest to ideal or perfect competition, notwithstanding market manipulation by central banks. According to the BIS, average daily turnover in global foreign exchange markets is estimated at $3.98 trillion. Trading in the world's main financial markets accounted for $3.21 trillion of this.

Of the $3.98 trillion daily global turnover, trading in London accounted for around $1.36 trillion, or 34.1% of the total, making London the global centre for foreign exchange. In second and third places respectively, trading in New York accounted for 16.6%, and Tokyo 6.0%.

Foreign exchange trading increased by 38% between April 2005 and April 2006 and has more than doubled since 2001. This is largely due to the growing importance of foreign exchange as an asset class and an increase in fund management assets, particularly of hedge funds and pension funds. The diverse selection of execution venues such as internet trading platforms has made it easier for retail traders to trade in the foreign exchange market.

Because foreign exchange is an OTC (Over the Counter) market where brokers/dealers negotiate directly with one another, there is no central exchange or clearing house.

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The Cost of a Trade

Trading in the FX market is 'commission free', but it is not free to trade. Instead of your broker charging you a commission, you pay a spread, i.e. Pips (points). This means that you give away a number of Pips per trade to the Broker.

The Bid/Ask Spread is the difference between the price at which a bank or market maker will sell ("ask", or "offer") and the price at which a market-maker will buy ("bid") from a wholesale customer. This spread is minimal for actively traded pairs of currencies, usually 3 Pips. For example, the bid/ask quote of EUR/USD might be 1.2200/1.2203 for a retail broker. Minimum trading size for most deals is usually 100,000 units of currency, which is a standard "lot".

These spreads might not apply to retail customers at banks, which will routinely mark up the difference. Spot prices at market makers vary but on EUR/USD are usually no more than 3 pips wide (i.e. 0.0003).

Commercial Companies

An important part of this market comes from the financial activities of companies seeking foreign exchange to pay for goods or services. Commercial companies often trade fairly small amounts compared to those of banks or speculators, and their trades often have little short-term impact on market rates. Nevertheless, trade flows are an important factor in the long-term direction of a currency's exchange rate. Some multinational companies can have an unpredictable impact when very large positions are covered due to exposures that are not widely known by other market participants.

Central Banks

National central banks play an important role in the foreign exchange markets. They try to control the money supply, inflation and/or interest rates, and often have official or unofficial target rates for their currencies. They can use their usually substantial foreign exchange reserves to stabilise the market. The mere expectation or rumour of central bank intervention might be enough to stabilise a currency, but aggressive intervention might be used several times each year in countries with a dirty float currency regime (a floating exchange rate system which is not controlled entirely by the market forces of demand and supply.) Central banks do not always achieve their objectives. The combined resources of the market can easily overwhelm any central bank. Several scenarios of this nature were seen in the 1992–93 ERM collapse and in more recent times in South-East Asia.

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Hedge Funds

A hedge fund is a private investment fund open to a limited range of investors that is permitted by regulators to undertake a wider range of activities than other investment funds and also pays a performance fee to its investment manager. Hedge Funds have gained a reputation for aggressive currency speculation since 1996. They control billions of dollars of equity and may borrow billions more, and thus may overwhelm intervention by central banks to support almost any currency, if the economic fundamentals are in the hedge funds' favour.

Investment Management Firms

Investment management firms (who typically manage large accounts on behalf of customers such as pension funds and endowments) use the foreign exchange market to facilitate transactions in foreign securities. For example, an investment manager bearing an international equity portfolio needs to purchase and sell several pairs of foreign currencies to pay for foreign securities purchases.

Retail Forex Brokers

There are two types of retail brokers offering the opportunity for speculative trading: retail forex brokers or market makers. Retail traders (individuals) are a small fraction of this market and may only participate indirectly through brokers or banks.

Most Traded Currencies

Currency distribution of reported FX market turnover

Rank Currency ISO 4217 code (Symbol) % daily share (April 2007) 1 United States dollar USD ($) 86.3% 2 Euro EUR (€) 37.0% 3 Japanese yen JPY (¥) 16.5% 4 Pound sterling GBP (£) 15.0% 5 Swiss Franc CHF (Fr) 6.8% 6 Australian dollar AUD ($) 6.7% 7 Canadian dollar CAD ($) 4.2% 8-9 Swedish krona SEK (kr) 2.8% 8-9 Hong Kong dollar HKD ($) 2.8% 10 Norwegian krone NOK (kr) 2.2% 11 New Zealand dollar NZD ($) 1.9% 12 Mexican Peso MEX ($) 1.3%

Other 16.8% **Total 200%**

The main trading centre is London but New York, Tokyo, Hong Kong and Singapore are all important centres as well. Banks throughout the world participate. Currency trading happens continuously throughout the day; as the Asian trading session ends, the European session

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begins, followed by the North American session and then back to the Asian session, excluding weekends.

There is little or no 'inside information' in the foreign exchange markets. Exchange rate fluctuations are usually caused by actual monetary flows as well as by expectations of changes in monetary flows caused by changes in GDP growth, inflation, interest rates, budget and trade deficits or surpluses, large cross-border M&A deals and other macroeconomic conditions. Major news is released publicly, often on scheduled dates; so many people have access to the same news at the same time. However, the large banks have an important advantage; they can see their customers' order flow.

Currencies are traded against one another. Each pair of currencies constitutes an individual product and is traditionally noted XXX/YYY, where YYY is the ISO 4217 international three letter code of the currency into which the price of one unit of XXX is expressed (called base currency). For instance, EUR/USD is the price of the euro expressed in US dollars as in 1 euro = 1.5465 dollar. Out of convention, the first currency in the pair, the base currency, was the stronger currency at the creation of the pair. The second currency, counter currency, was the weaker currency at the creation of the pair.

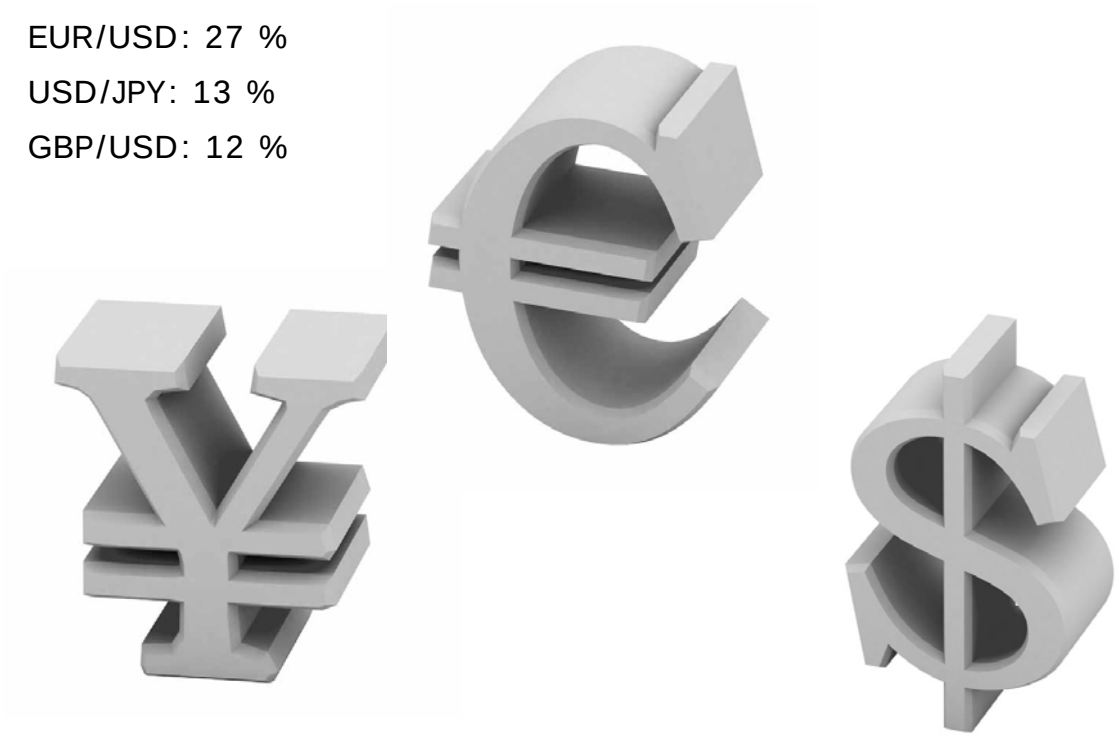
The factors affecting XXX will affect both XXX/YYY and XXX/ZZZ. This causes positive currency correlation between XXX/YYY and XXX/ZZZ.

The most heavily trade products on the spot market, according to the BIS study were:

EUR/USD: 27 %

USD/JPY: 13 %

GBP/USD: 12 %



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Factors Affecting Currency Trading

Although exchange rates are affected by many factors, in the end, currency prices are a result of supply and demand forces. The world's currency markets can be viewed as a huge melting pot in a large and ever-changing mix of current events; supply and demand factors are constantly shifting, and the price of one currency in relation to another shifts accordingly. No other market encompasses (and distils) as much of what is going on in the World at any given time as foreign exchange.

Supply and demand for any given currency, and thus its value, are not influenced by any single element, but rather by several. These elements generally fall into three categories: economic factors, political conditions and market psychology.

Economic Factors

Economic policy comprises government fiscal policy (budget/spending practices) and monetary policy (the means by which a government's central bank influences the supply and "cost" of money, which is reflected by the level of interest rates).

Economic conditions include the following:

1. Government budget deficits or surpluses. The market usually reacts negatively to widening government budget deficits and positively to narrowing budget deficits. The impact is reflected in the value of a country's currency.
2. Balance of trade levels and trends. The trade flow between countries illustrates the demand for goods and services, which in turn indicates demand for a country's currency to conduct trade. Surpluses and deficits in trade of goods and services reflect the competitiveness of a nation's economy. For example, trade deficits may have a negative impact on a nation's currency.
3. Inflation levels and trends. Typically, a currency will lose value if there is a high level of inflation in the country or if inflation levels are perceived to be rising. This is because inflation erodes purchasing power and thus demand for that particular currency. However, a currency may sometimes strengthen when inflation rises because of expectations that the central bank will raise short-term interest rates to combat rising inflation.

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4. Economic growth and health. Reports such as gross domestic product (GDP), employment levels, retail sales, capacity utilisation and others, detail the levels of a country's economic growth and health. Generally, the more healthy and robust a country's economy, the better its currency will perform, and the more demand for it there will be.

Political Conditions

Internal, regional, and international political conditions and events can have a profound effect on currency markets.

For instance, political upheaval and instability can have a negative impact on a nation's economy. The rise of a political faction that is perceived to be fiscally responsible can have the opposite effect. Also, events in one country in a region may spur positive or negative interest in a neighbouring country and, in the process, affect its currency.

Market Psychology

Market psychology and trader perceptions influence the foreign exchange market in a variety of ways:

1. Flights to quality. Unsettling international events can lead to a flight of quality with investors seeking a safe haven. There will be a greater demand, thus a higher price, for currencies perceived as stronger over their relatively weaker counterparts. The Swiss Franc has been a traditional safe haven during times of political or economic uncertainty.
2. Long-term trends. Currency markets often move in visible long-term trends. Although currencies do not have an annual growing season like physical commodities, business cycles do make themselves felt. Cycle analysis looks at longer-term price trends that may rise from economic or political trends.
3. "Buy the rumour, sell the fact". This market truism can apply to many currency situations. It is the tendency for the price of a currency to reflect the impact of a particular action before it occurs and when the anticipated event comes to pass, react in exactly the opposite direction. This may also be referred to as a market being "oversold" or "overbought". To buy the rumour or sell the fact can also be an example of the cognitive bias known as anchoring when investors focus too much on the relevance of outside events to currency prices.

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4. Economic numbers. While economic numbers certainly reflect economic policy, some reports and numbers take on a talisman-like effect — the number itself becomes important to market psychology and may have an immediate impact on short-term market moves. "What to watch" can change over time.
5. Technical trading considerations. As in other markets, the accumulated price movements in a currency pair such as EUR/USD can form apparent patterns that traders may attempt to use. Many traders study price charts in order to identify such patterns.

Financial Instruments

Spot, Forward, Future, Swap, Option, Exchange Traded Fund

The Spot Exchange Rate refers to the current exchange rate. The Forward Exchange Rate refers to an exchange rate that is quoted and traded today but for delivery and payment on a specific future date.

The Spot has the largest share by volume in FX transactions among all instruments and is the instrument most commonly traded by day traders.

A Spot transaction is a two-day delivery transaction (except in the case of the Canadian dollar, which settles the next day), as opposed to the futures contracts which are usually three months. This trade represents a “direct exchange” between two currencies, has the shortest time frame, involves cash rather than a contract, and interest is not included in the agreed-upon transaction. The data for this study come from the spot market.

Speculation

Controversy about currency speculators and their effect on currency devaluations and national economies occurs regularly. Nevertheless, economists have argued that speculators ultimately are a stabilising influence on the market and perform the important function of providing a market for hedgers and transferring risk from those people who don't wish to bear it, to those who do.

Currency speculation is considered a highly suspect activity in many countries. For example, in 1992, currency speculation forced the Central Bank of Sweden to raise interest rates for a few days to 500% per annum, and later to devalue the krona. A former Malaysian Prime Minister is one well-known proponent of this view; he blamed the devaluation of the Malaysian ringgit in 1997 on George Soros and other speculators.

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High Leverage

Definition

Margin can be defined as the use of credit or borrowed funds to improve one's speculative capacity and increase the rate of return from an investment, as in buying securities on margin. Essentially, the core idea of leverage is that investors can use less money to control bigger amount of investment so that investors can make more money when the price movement is in investors' favour.

The idea of margin (leverage) and floating loss is another important trading concept and is perhaps best understood using an example.

Most retail Forex market makers permit 100:1 leverage, but also, crucially, require you to have a certain amount of money in your account to protect against a critical loss point. For example, if a $100,000 position is held in EUR/USD on 100:1 leverage, the trader has to put up $1,000 to control the position. However, in the event of a declining value of your positions, Forex market makers, mindful of the fast nature of forex price swings and the amplifying effect of leverage, typically do not allow their traders to go negative and make up the difference at a later date. In order to make sure the trader does not lose more money than is held in the account, forex market makers typically employ automatic systems to close out positions when clients run out of margin (the amount of money in their account not tied to a position). If the trader has $2,000 in his account, and he is buying a $100,000 lot of EUR/USD, he has $1,000 of his $2,000 tied up in margin, with $1,000 left to allow his position to fluctuate downward without being closed out.

Typically a trader's trading platform will show him three important numbers associated with his account: his balance, his equity, and his margin remaining. If trader X has two positions: $100,000 long (buy) in EUR/USD, and $100,000 short (sell) in GBP/USD, and he has $10,000 in his account, his positions would look as follows: Because of the 100:1 leverage, it took him $1,000 to control each position. This means that he has used up $2,000 in his margin, out of a $10,000 account, and thus he has $8,000 of margin still available. With this margin, he can either take more positions or keep the margin relatively high to allow his current positions to be maintained in the event of downturns. If the client chooses to open a new position of $100,000, this will again take another $1,000 of his margin, leaving $7,000. He will have used up $3,000 in margin among the three positions. The other way margin will decrease is if the positions he currently has open lose money. If his three positions of $100,000 decrease by $5,000 in value (which is fairly common), he now has, of his original $7,000 in margin, only $2,000 left. If you have a $10,000

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account and only open one $100,000 position, this has committed only $1,000 of your money plus you must maintain $1,000 in margin. While this leaves $9,000 free in your account, it is possible to lose almost all of it if the speculation loses money.

Transaction Costs and Market Makers

Market makers are compensated for allowing clients to enter the market. They take part or all of the spread in all currency pairs traded.

In a common example, EUR/USD, the spread is typically three pips (3/100 of a cent). Thus prices are quoted with both bid and offer prices (e.g., Buy EUR/USD 1.4900, Sell EUR/USD 1.4903). That difference of three pips is the spread and can amount to a significant amount of money. Because the typical standard lot is 100,000 units of the base currency, those three pips on EUR/USD translate to $30 paid by the client to the market maker. However, a pip is not always $10. A pip is 1/100th of a cent (or equivalent), and the currency pairs are always purchased by buying 100,000 of the base currency. For the pair EUR/USD, the quote currency is USD; thus, 1/100th of a cent on a pair with USD as the quote currency will always have a pip of $10. If, on the other hand, your currency pair has Swiss francs (CHF) as a quote instead of USD, then 1/100th of a cent is now worth around $9, because you are buying 100,000 of whatever in Swiss francs.

FX Terms

What is the Forex Market?

The online trading environment for foreign exchange encompasses the largest, most dynamic capital market in the world with more than $1.5 trillion traded daily. The FX market is a continuous, 24/7marketplace open from Sunday afternoon (4 PM EDT) through to the close of the US markets on Friday (5 PM EDT). The FX market is where investors can trade one currency against another.

What is a Currency Cross?

Currencies are always priced in pairs. All trades take place between two different currencies resulting in the concurrent purchase of one currency and sale of another. For example, when you trade EUR/USD, the currency cross is Euros versus US dollars. One currency will be bought (long position) while the other currency is sold (short position).

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What is the Bid-Ask Spread?

The bid-ask spread is the buying and selling spread between two currencies. The bid price is the price at which the currency is sold. The ask price is the price at which the currency is bought. The difference between the bid price and the ask price is known as the bid-ask spread. The bid-ask spread differs between currency crosses with more common crosses (majors) having tighter spreads.

What is a Pip (Point)?

Defining a Pip

Currencies are quoted using 5 significant digits. The last digit, called a "pip", represents the smallest potential move in an exchange rate, and is very similar to ticks or points in other financial products. For example, if the currency was trading at 1.2277, a 10 pip increase in the ask price would result in a quote of 1.2287. Likewise, a 10 pip decrease in the ask price would result in a quote of 1.2267. Half-pips are a more recent development offering traders even tighter spreads and more competitive and transparent accuracy in pricing. When trading foreign exchange, the value of a pip is dependent on two variables – the amount of currency and the currency pair.

USD Value of a Pip

Below, we have calculated the US Dollar value of a one pip movement for some of the more frequently traded currency pairs. Please note in the below example, all values are calculated using 100,000 units of the base currency (the left-hand currency in the pair).

- EUR/USD = $10.00
- USD/CHF = $8.00
- USD/JPY = $9.06
- GBP/USD = $10.00
- USD/CAD = $7.92
- AUD/USD = $10.00
- EUR/CHF = $8.00
- EUR/JPY = $9.06
- EUR/GBP = $17.98

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Types of FX Trades

What is Spot?

A spot FX trade is an immediate execution of one currency against another at an agreed rate, settlement of which traditionally takes place two business days later. Client Station offers spot trading on streaming real-time prices for over 120 different currency crosses, with deep liquidity on the most liquid currency pairs. In the FX Trade module, if the Bid/Ask fields are highlighted green, then the platform is delivering a live-tradable price. To execute the spot trade, simply click the 'Enable' button to buy or sell the currency immediately.

What is a Forward Outright?

A Forward Outright is a trade that will commence at an agreed upon date (in the future). There is no centralised exchange for Forwards and forward trading is often customised to meet the needs of the buyer and seller. Forward Outrights are expressed as a price above (premium) or below (discount) the spot rate. The forward FX price is the sum of the spot price and the margin. This price is a reflection of the FX rate at the forward date where if the trade were executed at that rate there would be no profit or loss.

Defining Margin

Trading on margin means that an investor can buy and sell assets that represent more value than the capital in their account. Forex trading is typically executed on margin, and the industry practice is to trade on relatively small margin amounts since currency exchange rate fluctuations tend to be less than one or two percent on any given day. Margin, or leverage, implies that the investor is "gearing" his or her funds. Margin rates of 1% on the first $10,000 in your account and 2% on assets greater than that, are common in online trading. What this means is that a margin of 1.0% enables one to trade up to $1,000,000 even though there is $10,000 in the account. In terms of leverage this corresponds to 100:1, because 100 times $10,000 is $1,000,000, or put another way, $10,000 is 1.0% of $1,000.000.

Margin is a Powerful Accelerator

Using leverage opens the possibility to generate profits quickly, but increases the risk of rapidly incurring large losses. It is important to review the margin thresholds and limitations in your trading agreement to determine the range of trading activities you can undertake.

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Net Equity for Margin

This term is the absolute indicator of the extent of margin capability in your account. If your Margin required exceeds your Net Equity for Margin you must close or reduce positions, or send additional funds to cover your positions.

Trading on Unrealised Profits

You can trade on unrealised profits in your account. Margin calculations are based on the Net Equity for Margin which includes such unrealised profits and losses as are current in your account.

Margin Call

Traders must maintain the margins listed in their account at all times. If funds in an account fall below the margin requirement, a margin call is issued. A margin call requires the trader to immediately deposit more funds to cover the position or to close the position.

Trade Size

The amount of the trade size is limited by the margin position. For example, a trader with $10,000 in funds and 1% margin, can trade as much as $1,000,000; however taking a single position in this amount would be extremely unwise and generate a margin call if the trade were to tilt slightly.

Majors, Minors and Exotics

Margin rates vary according to the liquidity (available inventory) of different currency crosses. Lower rates apply to majors, higher rates to minors, and then highest margin terms for exotics.

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FX Order Types

Margin Order Types

The basic landscape in FX trading involves a number of order types that facilitate efficient transactions. Below, we have defined several of the most common terms.

1. **Limit -** A limit order is commonly used to enter or exit markets at a specified price or better than the market price. In addition, a limit order allows the trader to manage the length of time that the order is current or outstanding before it is cancelled.
2. **Stop if Bid -** A Stop if Bid order is used to buy or sell a currency if the Bid price breaches the specific level in the price field. Typically, Stop if Bid orders are used to buy a FX position in order to make sure a certain level is broken.
3. **Stop if Offer -** A Stop if Offer order is used to buy or sell a currency if the Ask price breaches the specific level in the price field. Typically, Stop if Offer orders are used to sell a FX position in order to make sure a certain level is broken. Linking orders offers traders a logical aggregation of order types that outline contingencies in market participation, making it much easier to trade in moving markets.
4. **One Cancels Other (OCO) -** This most common linked order, OCO, stipulates that if one part of the order is executed, then the other part is automatically cancelled. In FX trading, OCO often refers to a buy order and sell order linked together so that when one of the orders is executed, the other is cancelled. Consider the OCO as follows: the trader protects an existing position from loss (stop order) and ensures that profits are taken (limit order).
5. **If Done (ID) -** These contingent trade orders are also known as slave orders and become active only if the primary order is executed first. An example would be a working order to buy EUR/USD at 1.2500 and a contingent order to sell at 1.2400 Stop if Bid —if the first order is done.

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Chapter Three
Brokers and Platforms

Your Trading Coach says:

"The market is a fascinating arena which presents new opportunities each day. I trade with calm confidence, knowing the market cannot hurt me, unless I allow it to. Losing days come with the territory; in the long term, I know that I am a winner."

The Different Trading Entities

As a trader, there are a number of different entities to facilitate the processing of your transactions. While the relationships between each of these institutions are complex, you only need to be aware of how these relationships affect you and your position as a trader.

The four main bodies are as follows:

The Futures Exchange

An exchange is a marketplace in which securities, commodities, derivatives and other financial instruments are traded. The basic function of an exchange is to facilitate fair and orderly trading by efficiently disseminating price information to the market at large. Some well known futures exchanges include the Intercontinental Exchange (ICE), Chicago Mercantile Exchange (CME), Eurexchange (Eurex), Sydney Futures Exchange (SFE, now merged with the ASX), London International Financial Futures and Options Exchange (LIFFE), and the Singapore Commodity Exchange (SICOM) to name a few.

The Clearinghouse

The clearinghouse is an agency or separate corporation of a futures exchange that is responsible for settling trading accounts, clearing trades, collecting and maintaining margin monies, regulating delivery, and reporting trading data. Clearinghouses act as third parties to all futures and options contracts, acting as a buyer to every clearing member seller and a seller to every clearing member buyer. For every buyer of a futures contract there is a corresponding seller, and vice versa. In order to facilitate orderly and timely trading, the clearinghouse acts as a buyer to all market sellers, and seller to all market buyers. This eliminates the need for the original two parties to relocate each other to close the agreed transaction.

The Futures Commission Merchant

Futures Commission Merchants (FCM's) are firms or people engaged in soliciting or accepting and handling orders for the purchase or sale of futures contracts, subject to the rules of a futures exchange and, who, in connection with solicitation or acceptance of orders, accepts any money or securities to margin any resulting trades or contracts. If you trade commodities through an Introducing Broker (IB), they will have an FCM that clears or executes their trades.

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When you send in your funds to trade commodities, they will be sent to and put in the name of the clearing firm as Customer Segregated Funds.

Introducing Broker

An Introducing Broker (IB) is a futures broker who has a direct relationship with a client, but delegates the work of the floor operation and trade execution to an FCM or Clearing Broker. The FCM is usually a close partner of the IB. This is done to increase efficiency and lower the work load for futures brokers. It allows the IB to focus on the client while the FCM focuses on trading floor operations.

Choosing a Broker

To trade futures, a trader must first open an account with a ***broker***, and the process of selecting a broker is not necessarily simple. The choice of broker will depend largely upon the commission charged by the broker, the margins offered, the sort of settlement of purchases and sales, and the level of service required. However it is important that other considerations are taken into account. In choosing a commodity futures broker, several factors should be considered, for example their clearing arrangements with an FCM, the length of time they've been in business, and their track record as a whole, including issues of ethics and standards.

It is recommended that traders compare the prices and services offered by consulting with a broker comparison website, such as www.yourbroker.com.au You can also collect referrals from friends and associates. There is no rule against having more than one broker, but just remember to sell shares through the same broker from whom you bought them, to avoid administrative complications.

There are both discount brokers and full service brokers available. The criteria for selecting either a discount or full service broker depends upon the support and the services you need to effectively trade the markets. Regardless of which type is chosen, the bottom line depends heavily upon finding an efficient firm that will provide good execution performance.

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Discount Brokerage: A discount online brokerage firm allows traders to make all the decisions about how to trade their individual accounts. They act simply as a conduit between the exchange and the trader. Apart from keeping you informed of account balance and margin status, service is limited. If you don't need the extra attention and are confident in your trading abilities, this is the most economical way to trade.

Full Service Brokerage: If you're following several markets, you may want the experience and assistance of a full service brokerage firm. Your trading strategies will be a joint effort between you and your broker. If you're new to futures trading, you might feel more comfortable with the extra attention that a full service brokerage extends. A full service firm offers you advice on investments currently in the news, provides you with data so that you'll be knowledgeable in several areas, and contacts you regularly with trading advice. Transaction fees are generally higher because of the additional services they provide – "you get what you pay for."

Opening an Account

To open an account, your broker will send you a number of application forms, including acknowledgment that you understand the risks involved trading futures, and a form for your method of settlement (for example, BPay). For those dealing with an offshore broker, a form detailing taxation arrangements between the two jurisdictions is usually necessary. If the broker is to offer advice, then they will need some background information and some understanding of your investment goals. Once the application has been completed and accepted, an account in your name will be opened and ready to be funded. Usually funds can be transferred by wire, or by cheque, in the broker's base currency. You will then be given an account number which will allow you to set up your trading platform...

Brokerage Fees

Brokers naturally charge a fee for the services offered. This is mostly through the execution of trades, and a fee is charged for each order that is 'filled' or executed on your behalf. As futures traders, you'll pay a brokerage fee each time you buy and each time you sell a futures contract. This is referred to as a "round trip" or "round turn". Brokers do not generally charge for advice or for information provided.

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Electronic trading via the internet is considerably cheaper and definitely much faster than telephoning orders to your broker. Brokerage rates can vary substantially, depending on the service provided, data feed source and exchanges. They can be as low as US$5.00 per contract, to US$15.00 and even more. The speed and effectiveness of these systems is improving all the time, as is the availability of information and access to foreign markets. The internet now makes it relatively simple and inexpensive for a small private trader to become an international investor.

Platforms and Data Suppliers

Electronic trading has levelled the playing field to a large degree, especially for retail traders. Transactions can be entered and exited in a totally transparent environment, without fear of market makers utilising inside knowledge to manipulate price, or of institutions pushing their orders to the front of the queue. Present day technology enables a single contract trader to be in front of the queue if he or she is nimble enough. Similarly, the technical trader has access to the same huge amount of streaming data as the professional players. If sufficiently skilled, an independent trader executing orders with a single computer from their home office can quite easily match it with the “big boys”.

In order to confidently execute trades via the internet, it’s important that equipment and software is of sufficient quality and quantity to allow a trader quick and efficient access to the market. While it’s possible to trade with a bare-bones dialup internet connection, when hard earned money is on the line, it’s wise to invest in the fastest public broadband connection available. Probably more important than the connection speed is the reliability of the connection. Before signing up to a lengthy contract with an ISP, research your options by searching the web for reviews and comparisons of the many service providers in the marketplace.

Hardware

While the amount and type of computer equipment that traders own is going to depend on their individual financial resources, it’s important to understand that this area is probably the only part of trading where the trader has total control. Scrimping on quality equipment can be false economy in the long run, particularly if you have a computer failure in the middle of a fast moving market.

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Random Access Memory (RAM) is the single most important component of a trading computer, and nothing less than 1 Gigabyte is adequate. A fast processor, a 40 to 80 Gigabyte hard drive, and a graphics card that allows the addition of multiple monitors should also be considered. A trading computer should be just that – reserved exclusively for executing trades. Emails, web browsing, and media downloads should be restricted to a different computer and both should be regularly checked for spy ware and viruses. Two effective (and free to download) applications for detecting and eliminating spy ware are *SpyBot Search & Destroy* and *Ad Aware*. A weekly scan with each program should keep computers free from processor-sapping and damaging spy ware invaders.

Software

Efficient day trading also demands state-of-the-art quoting software and trading platform. The time it takes for transactions to be entered and finalised is measured in milliseconds, even though the broker and/or exchange may be located on the other side of the world. The data needs to be streamed to the trader in real time, and the supplier should be sophisticated enough to provide high quality charting and execution software with the feed. YourTradingRoom.com recommends the use of NinjaTrader. The trading execution platform and all charts projected by our moderators in The Live Trading Room are provided exclusively by NinjaTrader.

Security Analysis: Deciding What and How to Trade

Analysis of financial markets is often arbitrarily divided into two broad disciplines, commonly known as fundamental analysis and technical analysis. Both forms of analysis are different, but in many cases complementary, methods of discerning which instruments are most likely to provide superior returns on investment. In general terms, this process is about selecting markets and instruments in which to trade or invest, and timing when to open and close trades or investments so as to maximise returns.

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Fundamental Analysis

Definition:
This is the analysis of the economic well-being of a financial entity as opposed to only its price movements.

When talking about stocks, fundamental analysis is a technique that attempts to determine a security's value by focusing on underlying factors that affect a company's *actual* business and its future prospects. Fundamental analysis approaches the decision-making process by attempting to determine the intrinsic value of a financial instrument. Conventional wisdom indicates that the price of an instrument that is trading for less than its intrinsic value should rise and the price of an instrument that is trading for more than its intrinsic value should fall.

Intrinsic value is estimated by examining the factors that affect supply and demand for whatever is underlying the financial instrument. For example: a company, a commodity, a currency, an interest rate or a market index. The fundamental analyst thus studies the causes of prices, or changes in prices, of financial instruments. He or she will therefore be able to indicate what *ought* to be future price direction.

The main problem with fundamental analysis is that it assumes that information is disseminated perfectly and that it is acted on rationally. Practical observation of markets suggests that these assumptions do not necessarily hold true in the real world, particularly in the short term. In the case of the long term "buy and hold" investor, this problem is minimal because it is generally accepted that prices will move as indicated by intrinsic value over the longer term. For shorter term traders, and particularly day traders, fundamental analysis is of lesser value.

Technical Analysis

Definition:
A method of evaluating securities by analysing statistics generated by market activity, such as past prices and volume.

Technical analysis approaches the decision-making process by examining the market for the financial instrument itself. The data from the market are primarily the price, volume and, in futures markets, the open interest. The technical analyst is not concerned

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with the value of whatever underlies the financial instrument, but with how the forces of supply and demand are impacting upon its price. He or she searches charts for patterns and other indicators of repetitive price behaviour by utilising contemporary and historical price data. Any signs of institutional entries or exits, or reactions by the mass of retail traders are plotted diligently by the technical analyst, either to be acted upon or stored for later reference. The technical analyst therefore studies changes in the level of supply and demand for the traded instrument directly, rather than indirectly via the factors affecting supply and demand for the underlying asset.

Investopedia.com provides an analogy...
In a shopping mall, a fundamental analyst would go to each store, study the product that was being sold, and then decide whether to buy it or not. By contrast, a technical analyst would sit on a bench in the mall and watch people go into the stores. Disregarding the intrinsic value of the products in the store, his or her decision would be based on the patterns or activity of people going into each store.

Liquidity
Definition:
The ability to convert an asset to cash quickly. Also known as "marketability".

An important factor in choosing an instrument to trade is its liquidity, which is a measure of the degree to which an asset or security can be bought or sold in the market without affecting the asset's price. Liquidity is characterised by a high level of trading activity, and the higher the liquidity, the easier and quicker it is to convert the asset to cash. Futures traders will receive the best execution fills where there is the greatest liquidity, whereas illiquid instruments may cause problems entering and exiting positions, which can be especially dangerous in the case of price gaps. If price were to suddenly blow through a stop loss position in an illiquid market, it's highly probable that the stop would not be triggered, thereby exposing the trader to unexpected and possibly substantial losses.

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Volume
Definition:
The number of shares or contracts traded in a security or an entire market during a given period of time.

Volume is an important indicator in technical analysis and is mainly used to measure the strength of a move in the market. If the market was to move upwards on “thin” volume it can indicate that the move may not be significant. A move with “heavy” volume is generally regarded as being significant as it involves a larger amount of market participants with greater conviction. Volume is also measured by the total amount of transactions made in a trading session.

Ideally, when choosing a market to trade, both liquidity and total volume should be considered. Choosing instruments with high volume and liquidity will provide the trader with the flexibility and consistency they need to enter and exit positions effortlessly, thereby ensuring the best possible chance for success.

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Chapter Four
Charts

Your Trading Coach says:

“The principle is competing against yourself. It’s about self-improvement, about being better than you were the day before.”

Charts and their Construction

Definition

A graph of a share price is commonly referred to in the industry as a chart. It is effectively a historical record of price activity.

A trade is essentially an agreement between two parties to transfer ownership of futures contracts. One party is the seller and the other the buyer with both traders agreeing on a price at one moment in time. A market is therefore composed of a continuous stream of prices that originate from such trades made through an exchange. In earlier times, these trades were transmitted to interested parties via a ticker tape machine. The 'ticker' is still available through some live computer programs and cable TV business channels.

There are a number of problems with this method of following a market, the most obvious being memory limitations. If the last 'tick' was at say 3763, is this price relatively low or high compared to prices an hour ago, a day ago, or even weeks, months or years ago? Although it is possible to trade without any historical price knowledge, such knowledge is certainly useful.

To overcome such problems, technical analysts use various charting methods. The general approach is to represent the continuous stream of prices in a condensed form. There are a number of different styles of chart:

- OHCL Bar chart (open-high-low-close)
- Candlestick chart
- Point Break chart
- Line on Close chart

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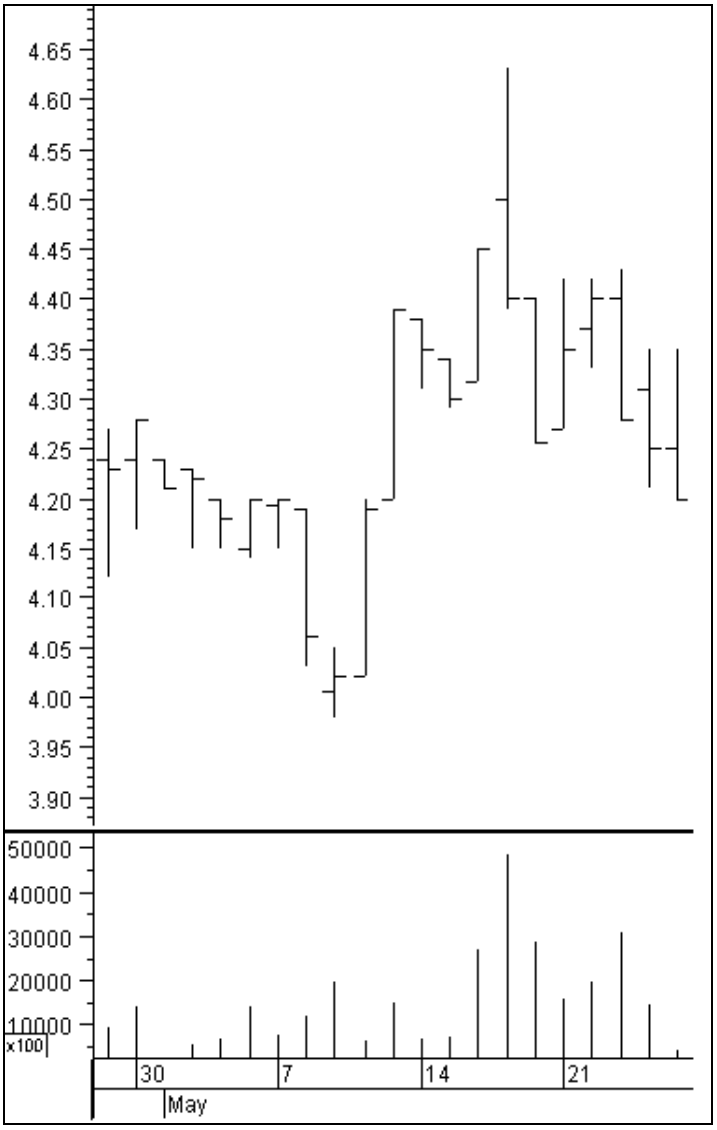
Bar Chart



The bar chart is one of the most commonly used styles of chart due to its high degree of usefulness. A bar chart is read from left to right. The top section of the bar chart represents price activity, while the histogram graph in the bottom section of the chart represents volume. The diagram above is a bar chart where each bar represents a single day's trading. Each day's price activity bar has a corresponding bar in the lower section; the volume of shares transacted for that day. Each bar in a bar chart may represent a time period other than a day; a bar chart may represent a week's trading per bar (a *weekly* bar chart), for instance, or indeed a bar may represent an hour's trading (an *hourly* bar chart) or even just a minute (a *one minute* bar chart).

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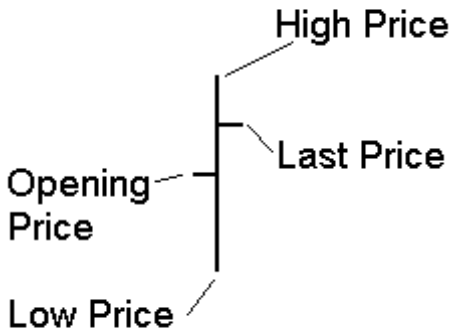
Examining one of the bars in a bar chart in detail shows the four significant points of the period's trading (recalling that a period may be a day, a week, an hour and so on).



These bar charts are sometimes referred to as an "Open-High-Low-Close" chart (OHLC). The last price becomes the closing price once the market has closed for the day.

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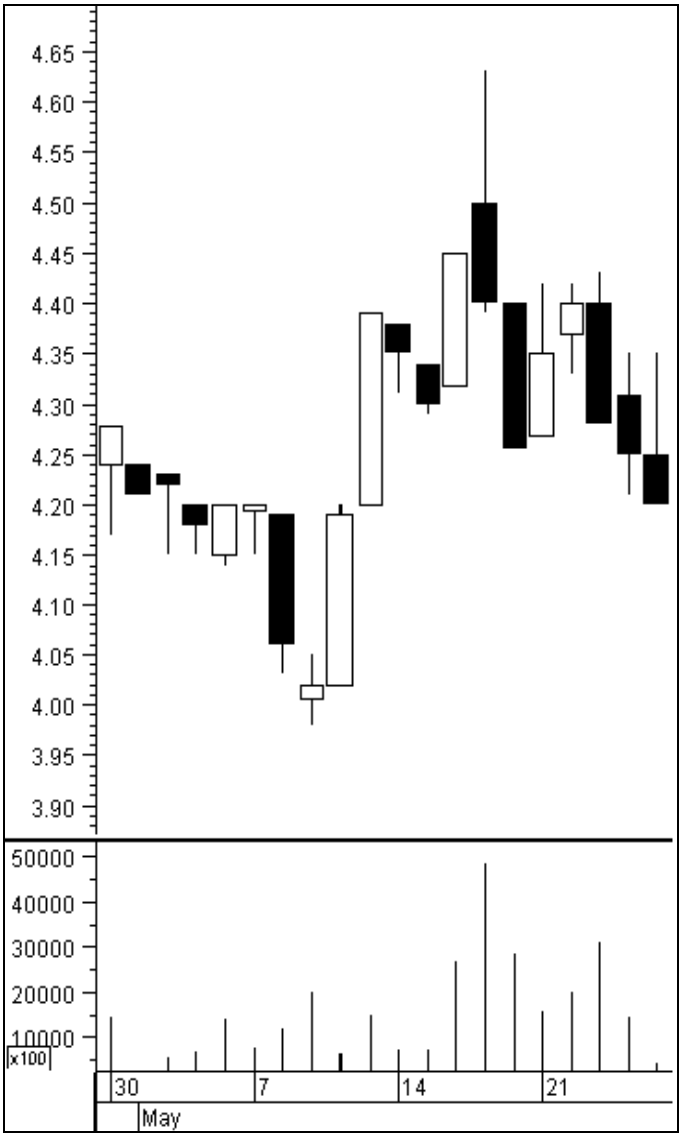
Candlestick Chart



A candlestick chart, another of the most commonly used charts, represents exactly the same information as a bar chart, but in a slightly different format. The example above is a daily candlestick chart, representing the same share and time period as our bar chart example earlier.

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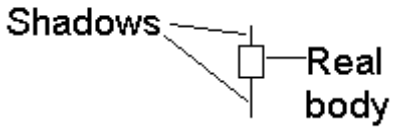
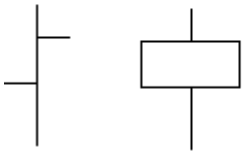
Candlestick charts may represent a time period other than a day; a week's trading per candle (a *weekly* candlestick chart), for instance, or indeed each candlestick may represent an hour's trading (an *hourly* candlestick chart) or just five minutes (a *five minute* candlestick chart) or any other time period.

Terminology of candlestick charts:



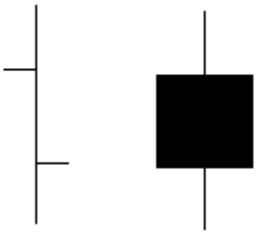
The rectangle in a candlestick bar is referred to as the *real body* of the candlestick. The lines protruding above and below the real body are referred to as *shadows*; an *upper shadow* or *wick,* and a *lower shadow*. If the opening price and/or closing price is at the same level as a high or low there is no shadow. In our first candlestick chart on the prior page, for example, the candlestick for May 10 has no lower shadow; the opening price in this instance was the low price for the day. On May 11 in our example there is neither a lower nor upper shadow, in this instance the open was the low price for the day while the high was the closing price for the day.

The candlesticks are also different colours.



Where the last price is above the opening price, the real body of the candlestick is left unfilled, or white.

Where the last price is below the opening price the real body of the candlestick is filled in, or black.



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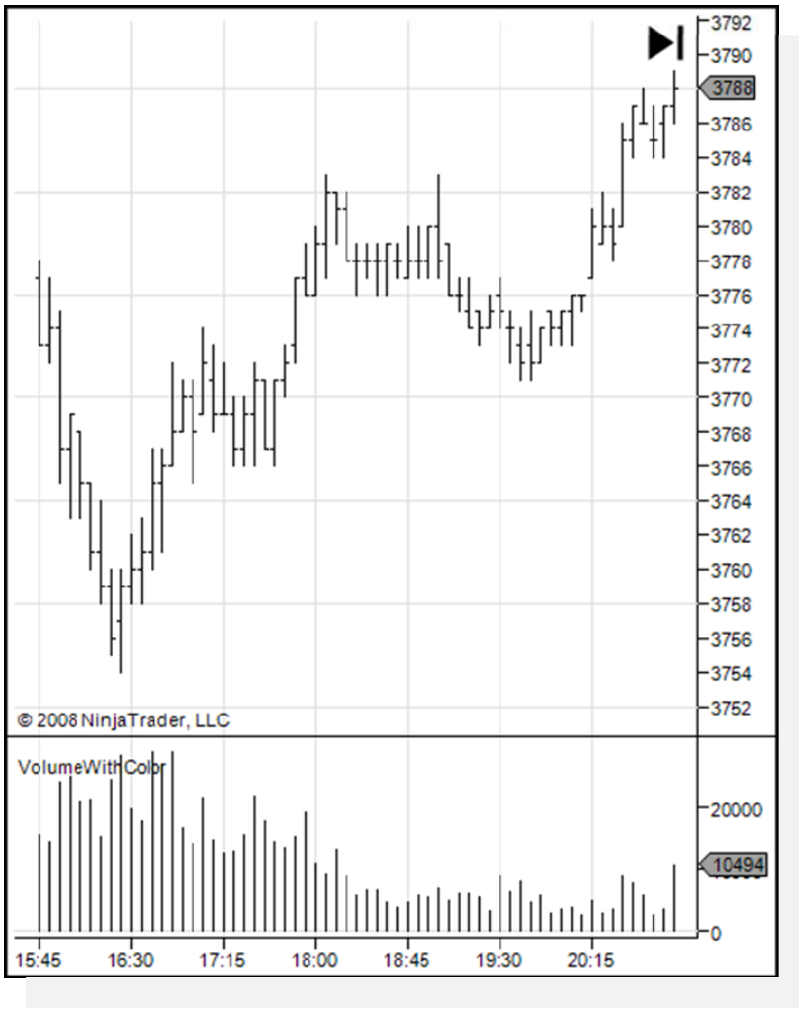
Candlesticks are often represented with colours other than black and white. The real body of a 'white' candlestick is often represented as green or blue while the real body of a 'black' candlestick is often represented as red.

The concepts and practice of using candlestick charts has been credited to the Japanese, where the first recorded uses of the candlestick concepts are found in the 1700's. It is only since the publication in 1991 of Steve Nison's book, *Japanese Candlestick Charting Techniques*, and his later work, *Beyond Candlesticks,* that the knowledge and use of candlestick charts spread outside Japan.

Candlestick charts lend themselves well to aiding an intuitive understanding of the market.

5 Minute Chart Comparison between Candlestick and Bar Charts

Here is an example of a five minute bar chart:



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Here is the same five minute chart, presented in Candlestick form:

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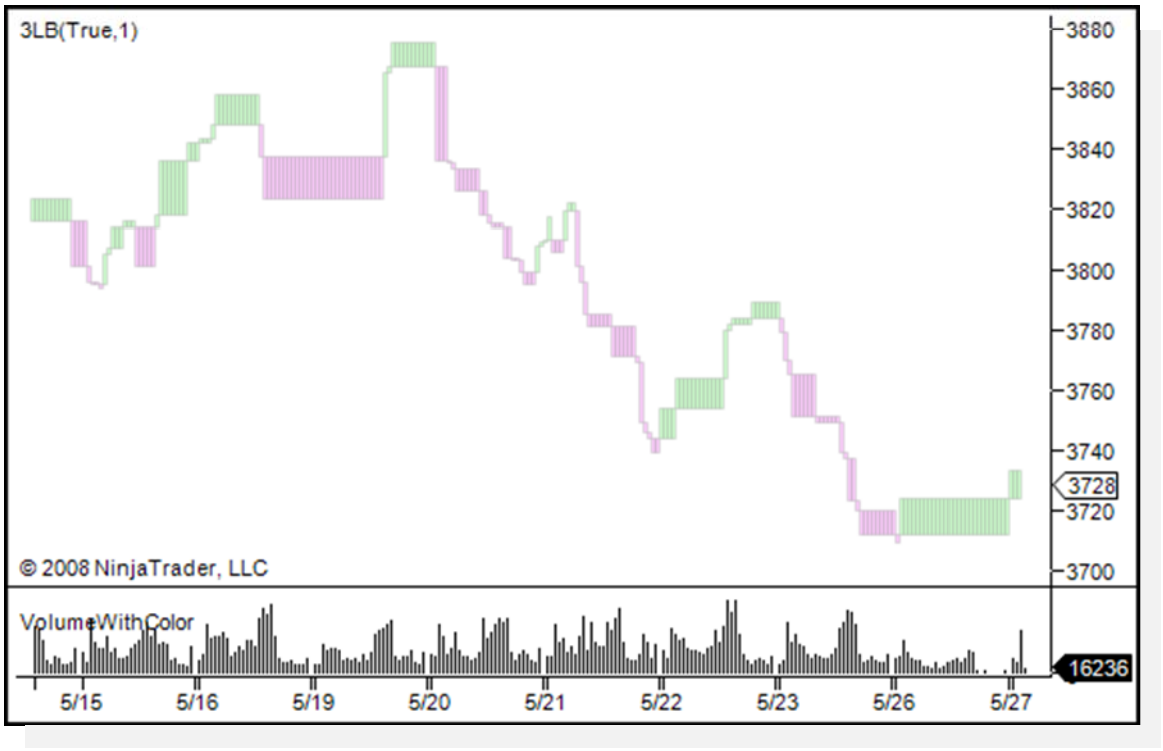
Point Break Chart

Point Break charts originate from Japan and were introduced to the western trading world by Steve Nison (author of *Beyond Candlesticks*). The most popular of these charts is the Three Line Break chart which gets its name from the default number of lines typically utilised. Using any time or tick-based period, a new green column (called a "line") is added if the current bar closes above the previous high price. A new red line is drawn if the close makes a new low. If there is neither a new high nor low, no lines are drawn. If a rally is powerful enough to form three consecutive blue lines, then the low of the last three blue lines must be exceeded before a red line will be drawn. Conversely, if a sell-off is powerful enough to form three consecutive red lines, then the high of the last three red lines must be exceeded before a new blue line will be drawn.



The standard method of trading the three-line break is to buy upon the formation of a new green line, and to sell once a new red line has formed. Remembering that the market must close above three consecutive blue lines (in the case of a buy), or below three consecutive red lines (in the case of a sell) before the opposite coloured line is drawn, it means that price has often penetrated quite a distance through the break point and therefore substantially away from an ideal entry position.

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Line Chart

The line chart is the simplest method and is commonly seen in newspapers and broker reports. One simply connects each bar's closing price on a price/time graph to represent the price history. The only consideration here is the generally accepted use of the close and not some other price formed during the day. The reason is that the close is an important price since most traders and companies use it to value a portfolio and to check stock prices. Clearly a lot of useful information (such as highs and lows) is missing from the chart and so some analysis techniques will be impossible. For this reason line charts are not generally recommended to serious traders.

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Chapter Five
Candlesticks

Your Trading Coach says:
“I am innovative and creative. The challenges I face will melt away when I apply fresh, original thinking to them.”

Candlestick Formations

Since Steve Nison introduced this Japanese charting method to the western trading world in the early 1990's, candlesticks have revolutionised technical analysis of markets. Although on the surface candles appear to deliver the same information as simple bar charts, i.e. a given period's opening, high, low and closing price, in actual fact they tell us much more.

"Candle charts will pictorially display the supply-demand situation by showing who is winning the battle between the bulls and the bears. Bar charts do not.

"Like bar charts, candle charts will show the trend of the market, but candle charts add another dimension of analysis by revealing the force behind the move.

"Bar charts can often take weeks (daily bars) to transmit a reversal signal. However, candle charts will often send out clues of imminent reversals in one to three sessions (periods). The result is that candle charts often provide the opportunity for more timely trades."

- ***Steve Nison, 'Beyond Candlesticks'***

Although Japanese Candlestick trading signals consist of approximately 40 reversal and continuation patterns, there are only 12 that a trader needs to learn to have an effective method of confirming the main yourtradingroom.com strategies.

On the following pages you will find diagrams of these common and reliable "bullish" and "bearish" candle formations. These signals should not be traded in isolation, but rather as confirming signals for the yourtradingroom.com strategies. A copy of these formations hanging on the wall next to your computer will help train you to recognise the signals as they occur.

Bulls and Bears - definition

The terms **bull market** and **bear market** describe upward and downward movements respectively and can be used to describe either the market as a whole or specific sectors and securities (stocks). The expressions "bullish" and "bearish" can also mean optimistic and pessimistic respectively ("bullish on technology stocks," or "bearish on gold", etc).

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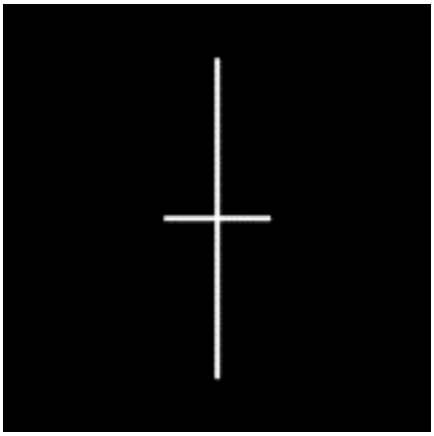
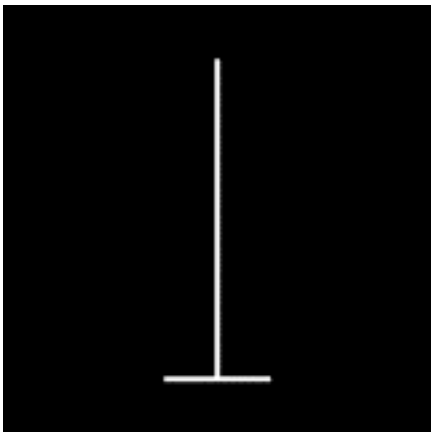
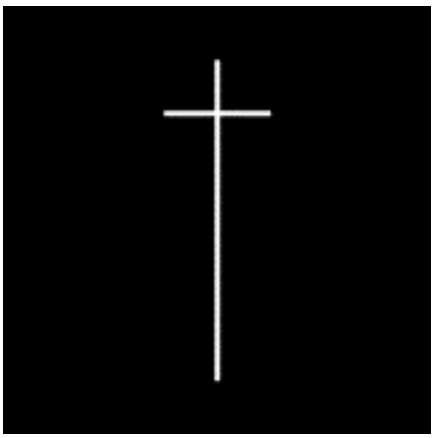


The **Doji** signal consists just of one candle. It is formed when the open and the close occur at the same level or very close to the same level in a specific timeframe. It clearly indicates that the Bulls and the Bears are at equilibrium, or are indecisive. The Doji, appearing at the end of an extended trend, has significant implications. The trend may be ending. Candlestick devotees sell immediately when a Doji appears at the top of a trend, in an overbought area. Conversely, a Doji seen at the bottom of an extended downtrend requires buy signals on the next candle to confirm the reversal. Otherwise, the weight of the market could take the trend lower.



The **Gravestone Doji** is formed when the open and the close occur at the low of the bar. It is found occasionally at market bottoms, but it's usually noticed at market tops. The name, Gravestone Doji, is derived from the candles appearance.

The **Long-legged Doji** has one or two very long shadows. Long-legged Doji's are often signs of market tops. If the open and the close are in the centre of the session's trading range, the signal is referred to as a **Rickshaw Man**. The Japanese believe these signals to mean that the trend has "lost its sense of direction."



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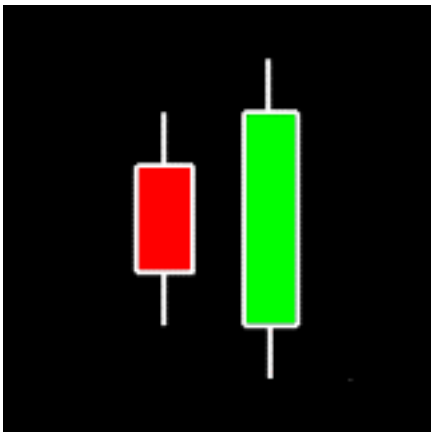
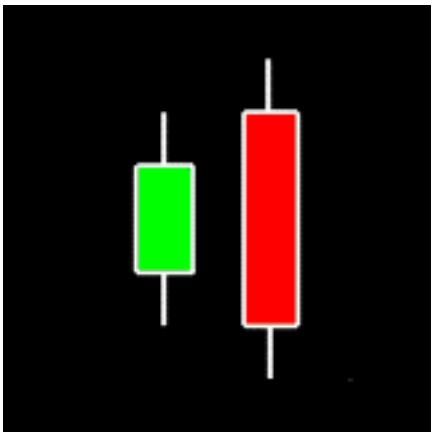
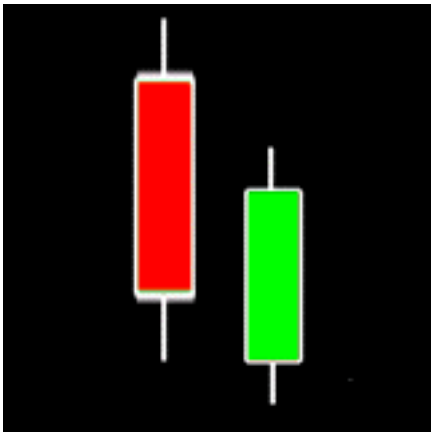


The **Bullish Engulfing** pattern is a major reversal pattern comprised of two opposite coloured bodies and is formed after a downtrend. It opens lower than the previous candle's close and closes higher than the previous candle's open. Thus, the up candle completely engulfs the previous down candle.



The **Bearish Engulfing** pattern is a major reversal pattern comprised of two opposite coloured bodies and is formed after an uptrend. It opens higher than the previous candle's close and closes lower than the previous candle's open. Thus, the down candle completely engulfs the previous up candle. Engulfing can include either the open, or the close, being equal to the open or close of the previous candle, but not both.



The **Piercing Pattern** is composed of a two-candle formation in a downward trending market. The first candle closes below its open (i.e. a down candle), a continuation of the existing trend. The second candle opens below the low of the first candle and closes more than midway up the first candle's body, near or at its high.

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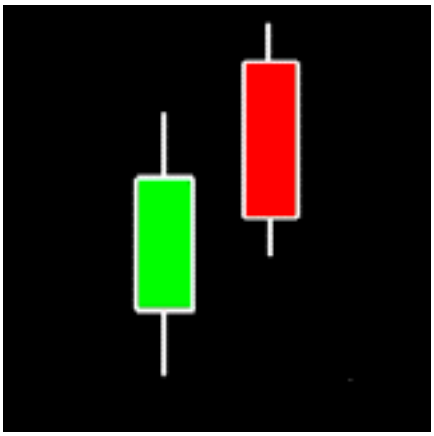
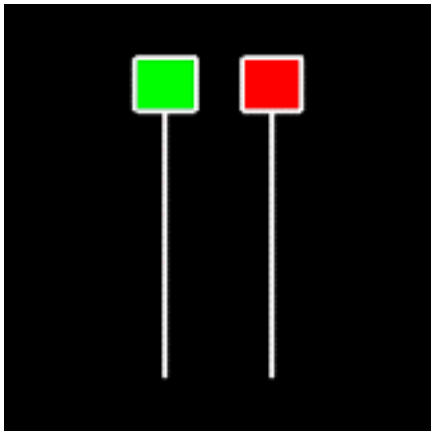
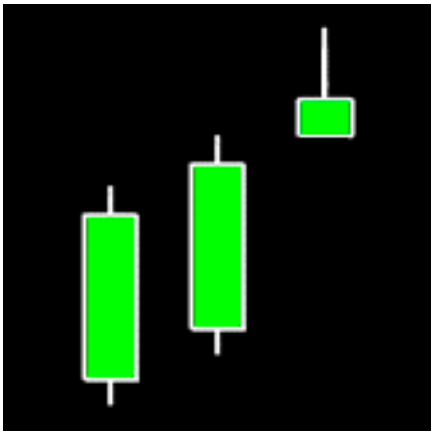


Dark Cloud Cover is the bearish equivalent to the Piercing pattern. The first candle in the pattern is a long up candle at the top end of a trend. The second candle opens higher that the high of the first candle. It closes at least half way down the first candle, and the further down it closes, the more convincing the reversal.



The **Hammer** (often called a **Hanging Man**) is comprised of one candle. It is easily identified by the presence of a small body with a shadow at least two times greater than the body. Found at the bottom of a downtrend, this shows evidence that the bulls have stepped in. The colour of the small body is not important but a green candle has slightly more bullish implications than the red body.



The **Shooting Star** is comprised of one candle and is found at the top of an uptrend. It alerts to the possibility that the top is near. The Shooting Star Formation, at the bottom of a trend, is a bullish signal and is known as an inverted hammer. It is important to wait for additional bullish confirmation signals before entering a long position.

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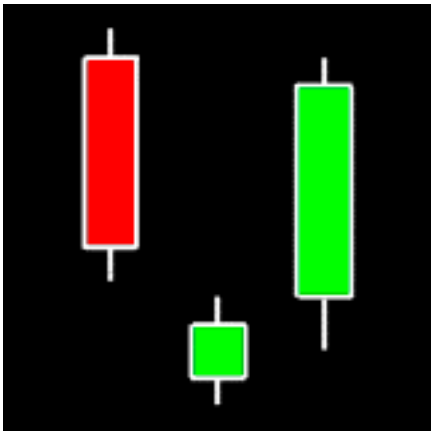
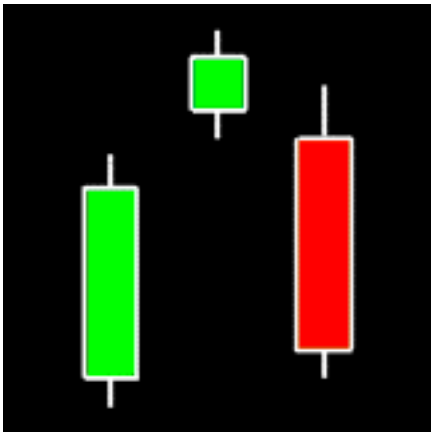


The **Morning Star** is a bottom reversal signal. Like the planet Mercury, it foretells a new dawn is about to occur, and that prices are likely to go higher. It is formed after an obvious downtrend and is formed with a long red body, usually a capitulation candle at the bottom of a long decline. The following candle will normally gap down; however the trading range of this candle should remain small. This candle is the star of the formation. The third candle has a strong upward move and represents the fact that the bulls have now stepped in and seized control. The optimal Morning Star signal would have a gap before and after the star candle.



The **Evening Star** pattern is a top reversal signal. It is exactly the opposite of the Morning Star signal. Like the planet Venus, it precedes darkness and indicates that prices could be about to go lower. It is formed after an obvious uptrend and is made by building a long green body at the top of such an uptrend. The next candle should gap up, with its trading range remaining. Again, this is the star of the formation. The third candle should move strongly down, which alerts to the probability that the bears have seized control. This candle should close at least halfway down the green candle which formed prior to the star (i.e. two periods ago). The optimal Evening Star signal would have a gap before and after the star candle.

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Chapter Six
Technical Analysis

Your Trading Coach says:

“Trading is a business, treat it like one. I maintain my focus at all times. I am disciplined at all times. No excuses!

Patterns and Technical Indicators

Definition:

Technical analysis is a method of evaluating securities by relying on the assumption that market data, such as charts of price, volume, and open interest, can help predict future (usually short-term) market trends.

In technical analysis, there is a starting premise that the market is made up of a large group of trading participants. The assumption is that this large group of people will behave in predictable patterns. The challenge for technical analysts is to find these patterns in the price movements of the security. The patterns tend to become obscured in the price trends, since outside events also tend to influence the movement of the market price. These outside events may add “noise” to the patterns which subsequently mask or change the price patterns of the security.

There are three main premises upon which technical analysis is based:

1. Everything is discounted and reflected in market prices;
2. Prices sometimes but not always move in trends, and trends persist; and
3. Market action is repetitive.

The true value of a security (an investment instrument issued by a corporation, government, or other organisation which offers evidence of debt or equity) at any point in time is determined solely by supply and demand, which is reflected in actual trading at each exchange. Technical analysts are not concerned with the underlying causes of a shift in supply and demand, but are instead interested in how it affects price. If demand is greater than supply; then prices will rise. If supply is greater than demand, prices will fall.

It is human nature to react to similar situations in consistent ways. Generally people will act, and react, the same in the future as they have in the past. A financial market reflects the actions of its participants, and because of this, technical analysts study it to predict how people are likely to respond to certain situations.

Technical analysts/traders recognise that when price moves in one direction the most reliable opportunities for profitable trades are presented. Technical traders also understand that price trends may be long or short term and that short term trend moves do not carry on in one direction indefinitely; a short term uptrend will be

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followed by a fall in prices which may bring prices down only a little, back to where they started from, or even to below where they started from. If prices, after a short term uptrend, fall back only a little before beginning to rise again, the share price may possibly be in a long term uptrend.

Here we will examine some of the methods and tools used by technical traders to understand price activity.

Studying Price Activity Directly from the Chart

A very simple way to understand price activity is to study how the price is behaving directly. While this is a very simple way of understanding price activity it is also the most powerful. Direct observation of how the price is behaving brings a trader closest to understanding the current relationship between supply and demand; and as understanding increases, so too does the potential for benefit, i.e. profit.

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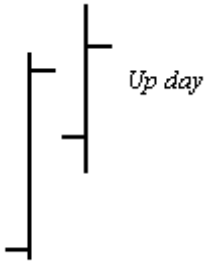
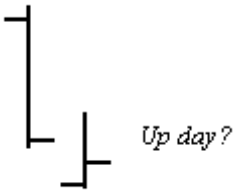
Let's begin with some very simple examples.

A day (note, the bars are referred to as "days", but a bar may represent some other time period) where the close is above the open is often referred to as an **up day.**

This makes sense, especially if the day has a high and higher low than the previous day, thus…



Labelling a day an "up day" when the high and low are lower than the previous day is more problematic! Such a day may appear in a chart thus…



This brings us to an important point. Price bars should be viewed in context. That is, the information conveyed in price bars needs to be viewed in relation to the preceding bars. We will come back to this point but let's continue with our examples just a little longer.

A day where the close is below the open is often referred to as a **down day.**

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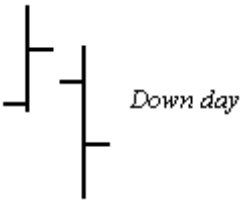
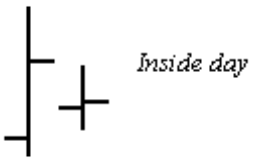
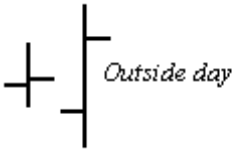
This makes sense, especially if the day has a high and low which is lower than the previous day, thus…





A day where the high is lower than the previous day's high *and* the low is higher than the previous day's low, is referred to an **inside day.**

A day where the high is higher than the previous day's high *and* the low is lower than the previous day's low, is referred to an **outside day.**



We have now, with our definitions of inside and outside days, introduced the idea of considering a bar in the context of the bar that preceded it.

Let's now broaden our analysis a little to consider today's bar not only just in reference to the immediately preceding bar, but in reference to a greater number of preceding bars. This brings us to the concept of single price bars that can act as a sign that the price is potentially reversing its current short-term trend. Such bars are often referred to as **reversal days** (or *reversal bars* if considering a time frame other than daily bars). Prices do not move straight up or straight down, in a never-ending, linear trend. In an uptrend, prices can surge higher, followed by a fall back and vice versa.

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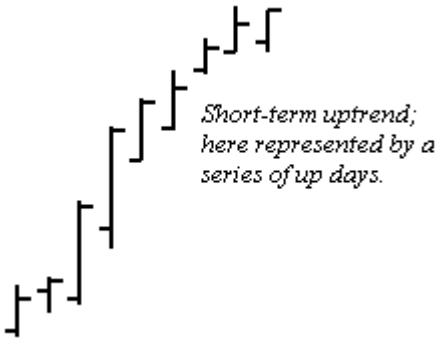
The value of learning these short term reversal indicators is clearly self-evident; if traders are aware of the potential for a reversal in a current short term trend, they can position themselves for profit. For example, let's say a trader is holding a number of FDAX futures contracts, and the price chart for that instrument forms a **reversal bar**. The trader is thus aware that the probability now is for a fall in price; hence a profit-taking sell of the contracts may now be in order.

Reversal Bar

A reversal bar is one that reverses the current short term trend. Let's say, for instance, the current short term trend is up.

This might be seen on a price chart as a series of up days, thus:



After an up move in prices over a few days, a reversal bar will be formed when we see a bar with a higher high than the previous bar, a higher low than the previous bar, but with a close below its opening price.

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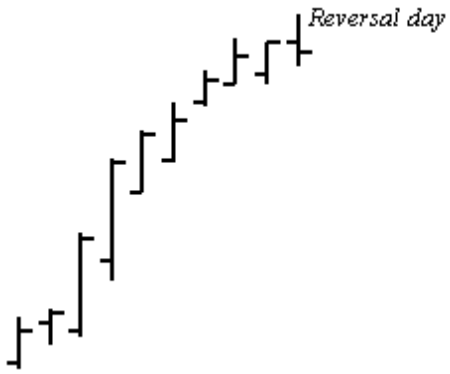
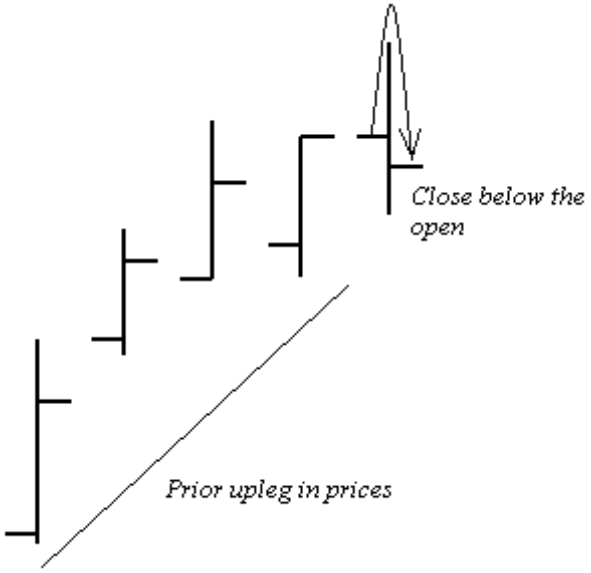
For example, the next bar in the price series for the chart above appeared thus:



Let's zoom in and see our definition of the reversal day a little closer:



Note the elements of the definition of a reversal bar that must be in place:

1. There must be some prior up leg in prices;
2. The bar of the reversal has a high higher than the previous bar, *and* a low higher than the previous bar, and;
3. The close is below the open.

Reversal bars can also form after down legs in price. The three elements needed for a reversal bar are simply the opposite of that required for a reversal bar of an up leg.

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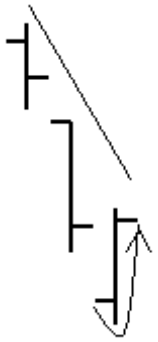
Note the elements of the definition of a reversal day that must be in place:



1. There must be some prior down leg in prices;
2. The bar of the reversal has a lower high than the previous bar, *and* a lower low than the previous bar, and;
3. The close is above the open.

Reversal bars should only be used as short term indicators. They are not necessarily an indication that a change in the long term trend is imminent; they are only indicative of the fact that the prior leg is now over and a short term reversal in trend is likely.

For instance, a reversal bar after an up leg in prices may bring on lower prices for the next few bars, it may bring on prices that don't fall to any great extent (the price moves "sideways"), or the price may even continue higher, confounding those expecting a price fall. How does one know if the reversal bar after an up leg is going to bring on lower prices, sideways prices, or no discernable reversal at all? In the financial market there are very few certainties, but the significance of a reversal bar (and hence it's potential to act as a reversal on prices) increases if:

5. The extent of the prior up or down leg increases (i.e. a sustained rise or fall in price over greater than ten to fifteen periods, or a very sharp percentage change in price over the previous bars), and…
6. The open and close of the bar are close to its low and high in relative terms;

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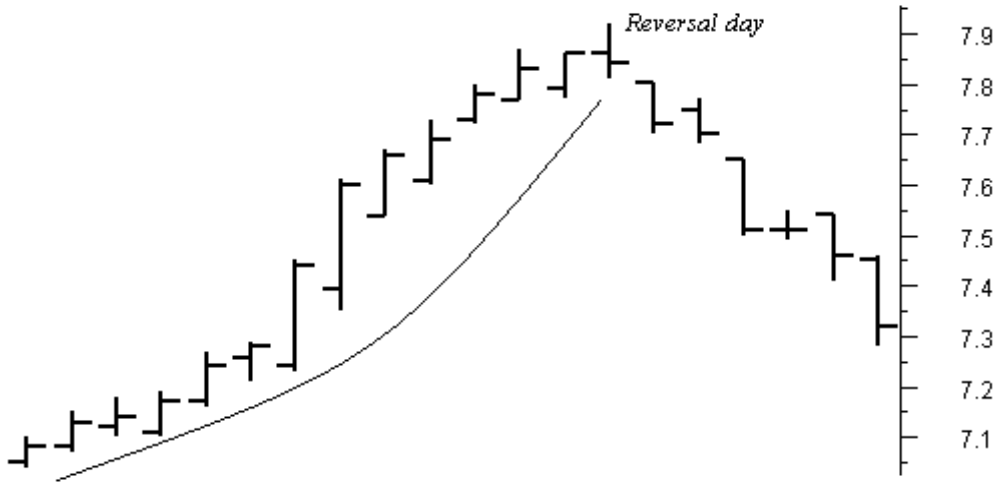
For example, here is a sustained up leg in prices – prices moved up consistently over the previous ten to fifteen periods and increased over 10%, followed by a reversal bar and a fall in prices:



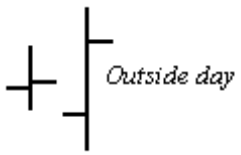
Other Types of Reversal Bars

There are other types of useful reversal bars to be aware of and that we will now define:

6. Outside reversal bars
7. Spike reversal bars
8. Signal bars
9. Two-bar reversals

Outside Reversal Bar

We have already defined an outside bar:



A bar where the high is higher than the previous bar's high *and* the low is lower than the previous bar's low.

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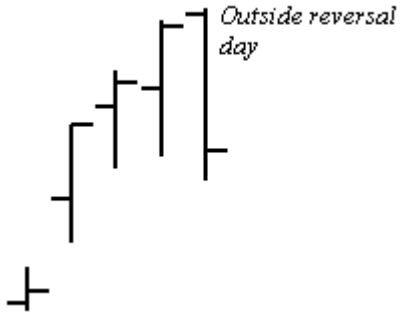
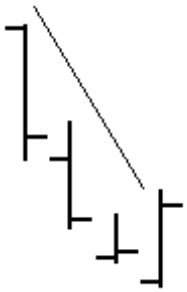
An **outside reversal bar** expands on this definition somewhat. After an up leg in prices, an outside reversal bar is one where the high is higher than the previous bar's high *and* the low is lower than the previous bar's low *and* the close is lower than the open:

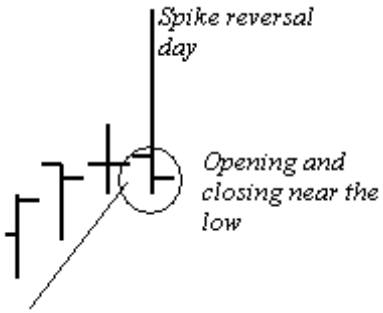


Of course, we can also have an outside reversal of a down leg of prices:



After a down leg in prices, an outside reversal bar is one where the high is higher than the previous bar's high *and* the low is lower than the previous bar's low *and* the close is higher than the open.

Spike Reversal Bars



A **spike reversal of an up leg** in prices has the opening and closing prices at the same, or close to the same price, and both are at, or close to, the low of the period's activity.

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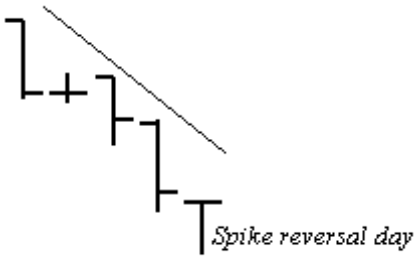
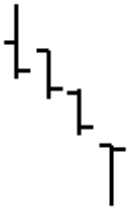
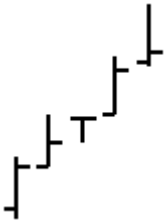
A **spike reversal of a down leg** in prices has the opening and closing prices at the same, or close to the same price, and both are at, or close to, the high of the period's activity.





A spike reversal of a down leg……

…..and of an up leg:



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Signal Bars

A **Signal top reversal bar** is defined as: following a prolonged move up in both price and time the market has:

- A higher high than the previous bar
- A lower close
- A close below the time-period's midpoint
- A close below the opening

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A **Signal bottom bar** is the inverse of the signal top, and is defined as following a prolonged move down in both price and time:

- The market has lower low than the previous bar
- A higher close
- A close above the time-period's midpoint
- A close above the opening.

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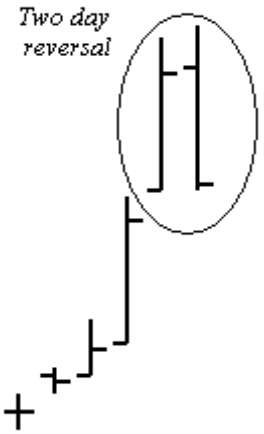
Two Bar Reversals

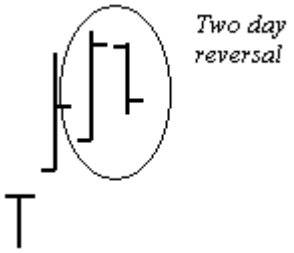
All of the reversal bars we have examined so far have occurred over a one period price action. In some circumstances, though, reversals come over two periods. It pays to also be aware of these two bar reversal signals.

A two bar reversal signal of an up leg in prices is defined as:

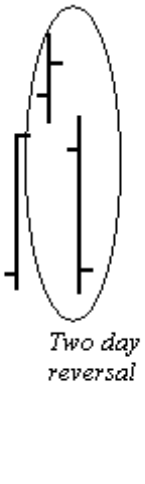
- On bar one the market makes a higher high than the previous bar, with an open in the lower 1/3 of the bar's range and the close in the upper 1/3 of the bar's range (so far it appears as quite bullish);
- On bar two the open is in the upper 1/3 of this period's range and the close is in the bottom 1/3 of the bar's range.



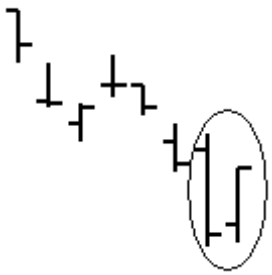
Another example:



And another:



There are, of course, also two bar reversals of down legs in price. The definition we are looking for of a two bar reversal of a down leg in price is:



- On bar one the market makes a lower low than the previous bar, with an open in the upper 1/3 of the period's range and the close in the lower 1/3 of the bar's range (so far it appears as quite bearish);
- On bar two the open is in the lower 1/3 of this period's range and the close is in the upper 1/3 of the bar's range.

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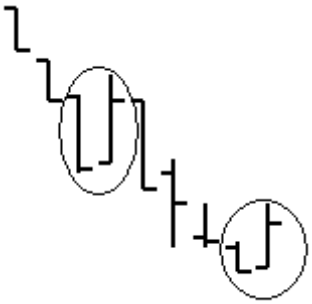
Another example:

And another two examples:



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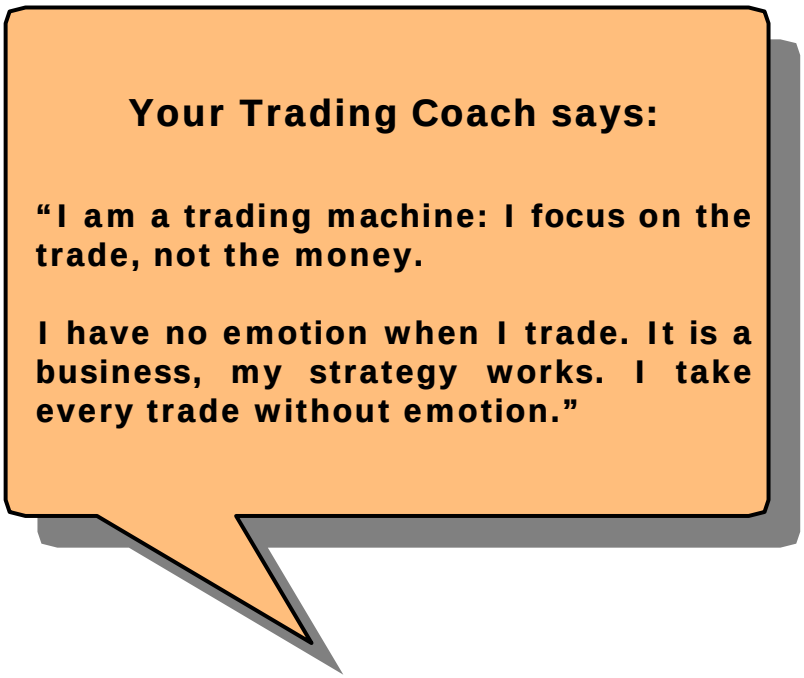
Chapter Seven
Technical Analysis: Moving Averages


Your Trading Coach says:
“I am a trading machine: I focus on the trade, not the money.
I have no emotion when I trade. It is a business, my strategy works. I take every trade without emotion.”

Moving Averages

Definition

A technical analysis term meaning the average price of a security over a specified time period (the most common being 20, 30, 50, 100 and 200 days), used in order to spot pricing trends by flattening out large fluctuations.

The moving average is one of the more basic and most frequently used technical analysis concepts. In essence, the moving average displays the average price over a period in a convenient form on a trading chart. The reason for calculating an average with any data set is to provide a simple representation for a series of numbers, which identifies what is 'normal' for that series. The reason for calculating moving averages in trading is quite similar. It is to smooth out minor fluctuations in the price data and thus provide a more 'normal' or 'average' representation of recent price action. The use of moving averages has naturally developed well beyond this over the years.

Simple Moving Average

To calculate a moving average, we simply add together a number of closing prices and divide by that number. This is the same method used to calculate any average. The average becomes 'moving' because as new data is added, we calculate a new average using the latest close, and drop off the first close used in the previous calculation. The new average is connected to the last calculation by a line, and as time unfolds, this line follows the market and represents the average price. The formula below should help to clarify the calculation process.

Simple Moving Average Formula

$$MA(n) = \frac{close(n-1) + close(n-2) + close(n-3) + \cdots + close(today)}{n}$$

where

- MA (n) = Moving Average over n periods
- n = period length
- close (n) = close n periods ago

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Parameters

The only parameter in the moving average formula is the length of time, or number of bars, being used as the averaging period. When it comes to trading, the choice of period is quite relevant. The characteristics of shorter and longer period moving averages vary considerably. Naturally this can have a significant impact on trading system results, depending upon how the average is used.

Short-Term Averages

Short-term averages hug closely to the price data. The advantage this offers is that changes in the price movement (such as a change of trend) will be reflected very quickly in the average. This does however create a problem. Relatively small changes in price can impact the moving average and trigger false entries in a system. Examples of short-term averages include 3, 5, or 10 bars on a chart.

Long-Term Averages

Long-term moving averages do not react to temporary price movements. This overcomes the weakness of short-term averages, namely being too sensitive to price. This lack of responsiveness to short-term price moves is also a disadvantage. Signals are not given until the move has well and truly begun, with the result being late signals. Any period longer than 50 constitutes a long-term moving average.

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Moving Average Systems

Definition

Moving averages can be used as a component of a system, or as the basis of a system itself. The simplest moving average system is based on the price bar and a single moving average.

Trading Action in a Simple Moving Average System

- Buy when the price closes above the moving average.
- Sell when the price closes below the moving average.

Longer term moving averages will tend to work a little better since the short-term averages tend to suffer 'whipsawing' in sideways markets. Whipsawing is basically a series of losing trades occurring in quick succession. This, of course, is not desirable to the live trader!

Moving average systems are essentially trend-following by nature. They will work in well trending markets, but suffer losses in consolidations. This tendency exists despite the period chosen.

To develop and improve the single moving average system, some traders use two or more averages. Such systems rely on the crossing of moving averages to generate signals.

Trading Action in a Dual Moving Average System

10. Buy when the shorter-term moving average crosses from below to above the longer-term average.
11. Sell when the shorter-term average crosses from above to below the longer term moving average.

The two moving averages on the example above can be used to demonstrate the methodology. This approach tends to be more effective than the single moving average system. In systems using three or more averages, a combination of crossovers is required to generate buy and sell signals.

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The Weighted Moving Average

Definition

The Weighted Moving Average is measured by averaging all the previous values over the given period.

The moving averages we have described so far are what are referred to as 'simple' moving averages. The simple refers to the method of calculation – that is, the closing prices are simply added together and then divided to come up with the current bar's moving average figure. In this way each bar's closing price in the moving average calculation is given equal value.

A criticism that can be attached to the simple moving average is that the prices at the earlier part of the time period included in the calculation should not be given an equal weight with the prices that have occurred more recently. The closing price nine periods ago is given the same weight in the calculation as the current closing price, for instance. Some analysts argue that recently occurring market activity, as reflected in the recent closing prices should be given more weighting in the calculation.

With this criticism in mind, there is an alternative way of calculating the moving average, which is to use a weighted moving average. A weighted moving average attaches greater 'weight' in the calculation to more recent closing prices.

The calculation of a five period (to keep the maths simple) weighted moving average is done as follows:

7. Current bar's closing price X 5
8. Plus previous bar's closing price X 4
9. Plus the close two bars ago X 3
10. Plus the close three bars ago X 2
11. Plus the close four bars ago X 1

All divided by (5+4+3+2+1) = 15

Notice the current bar's closing price is given five times as much weight as the closing price four bars ago.

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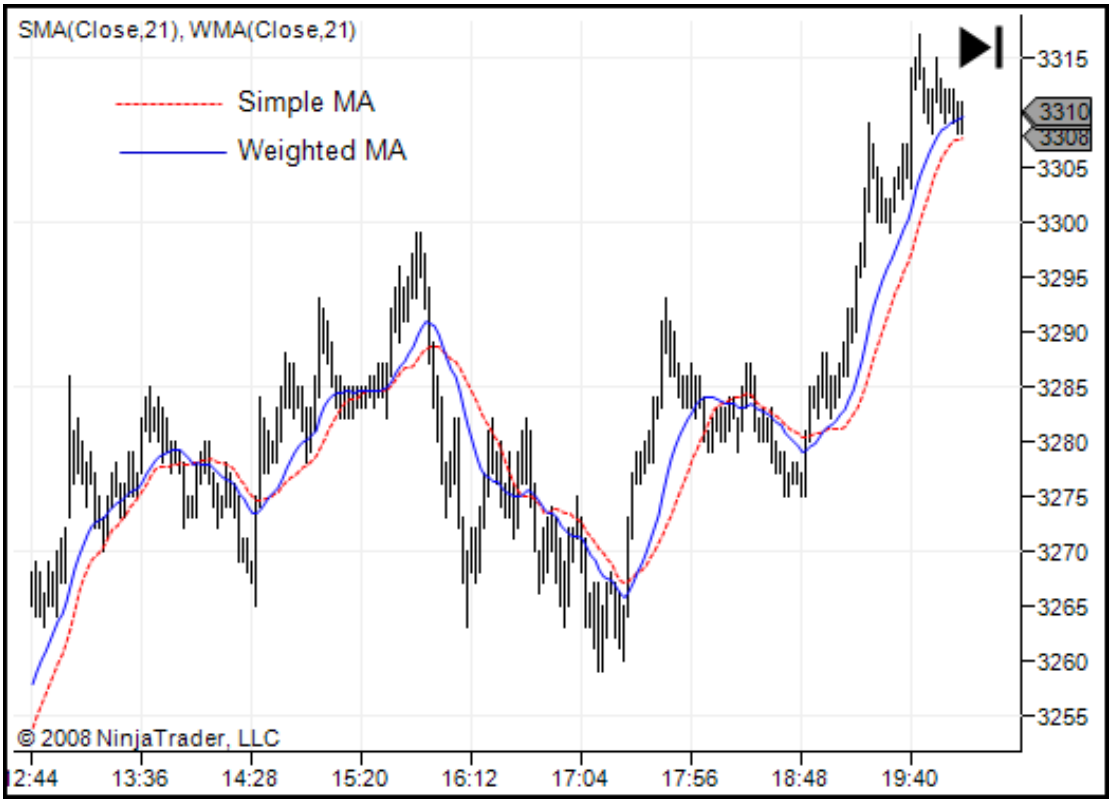
The calculation of a 10 period weighted moving average would be done as follows:

- Current bar's closing price X 10
- Plus previous bar's closing price X 9
- Plus the close two bars ago X 8
- Plus the close three bars ago X 7
- Plus the close four bars ago X 6
- Plus the close five bars ago X 5
- Plus the close six bars ago X 4
- Plus the close seven bars ago X 3
- Plus the close eight bars ago X 2
- Plus the close nine bars ago X 1

All divided by (10+9+8+7+6+5+4+3+2+1) = 55

Note in the 10 period example the current close is given a value of 10 times the value of the close nine bars ago.

The effect of using a weighted moving average is the line tracks the price more closely, and shows turns in trend more quickly than the simple moving average. We can see this by comparing a simple and weighted 10 period moving average, as shown on the chart below.



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Exponential Moving Averages

Definition

A moving average calculated by weighting recent values more heavily than older values.

An exponential moving average is similar to a weighted moving average, in that greater weight is attached to more recent price activity. The calculations differ, but nevertheless the same characteristics of all moving averages apply to exponential moving averages. They lag prices somewhat – and the greater the time period used, the greater the lag and the less responsive the moving average. Exponential moving averages are quite common, particularly as a component of other technical indicators (e.g. the Moving Average Convergence Divergence indicator).

The formula is calculated as follows:

Exponential Moving Average Formula

ExpMA (n) = 2/ (n+1)*(today's close) + ExpMA (n-1)*(1-2/ (n+1))

where

n = period

ExpMA (n) = Moving Average over n periods

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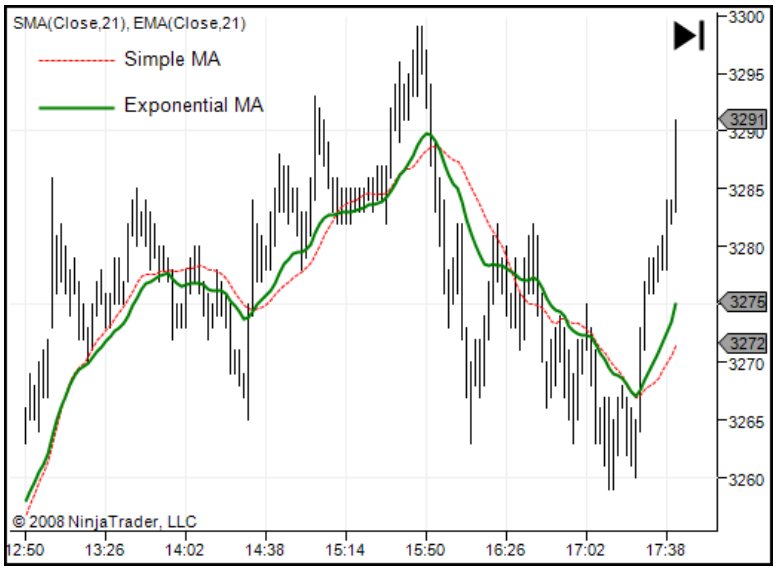


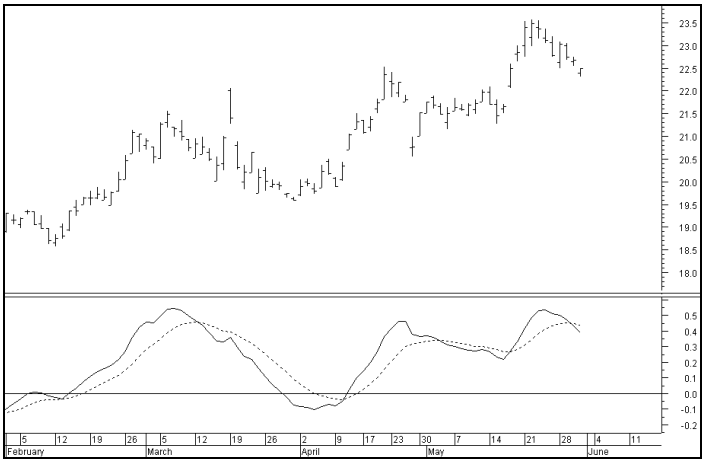
The chart left shows 10-period exponential and simple moving averages for comparison. You can see that the exponential moving average (solid green line) is a little more jagged and tends to hug the price bars more closely. The exponential moving average does this because the formula is more sensitive to recent prices.

Moving Average Convergence Divergence Indicator (MACD)

Definition

The MACD indicator is basically a refinement of the two moving averages system and measures the distance between the two moving average lines.

The MACD is unique in that it is both a trend indicator and an oscillator (see next chapter) Below is a price chart with a Moving Average Convergence Divergence indicator (MACD) plotted underneath. The MACD is relatively simple, but it is a very useful indicator of a trend. It's composed of two lines, the MACD line and the trigger line (dotted below).



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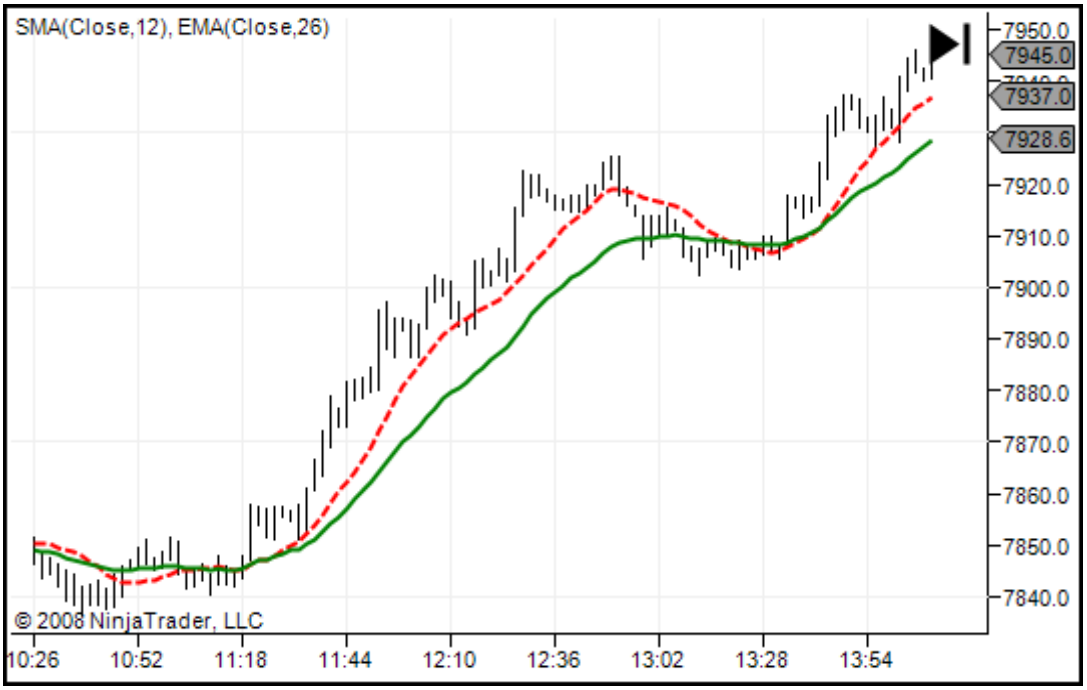
So, how are the two lines created?
Consider this chart:



It shows two moving averages, a 26 period exponential moving average and a 12 period moving average (the dotted line is the 12 period for those in any doubt – it follows the prices more closely than does the solid line).

The points to notice on this graph are:

- When the price moves up rapidly, as it did about 11:30 on the chart above, the shorter-term moving average moves up more quickly than the longer-term average (because the shorter-term average is more responsive to current prices). Also, the moving averages, during this period, *diverge* from each other, i.e. the gap between them grows.
- When the price is not trending rapidly, such as between 10:26 and 11:18, and again between 13:15 and 13:30, the shorter-term moving average flattens, as does the longer-term one and they *converge* towards one another.

- Notice also that when the short-term moving average crosses the long-term moving average, this is a signal of a potential change in trend.

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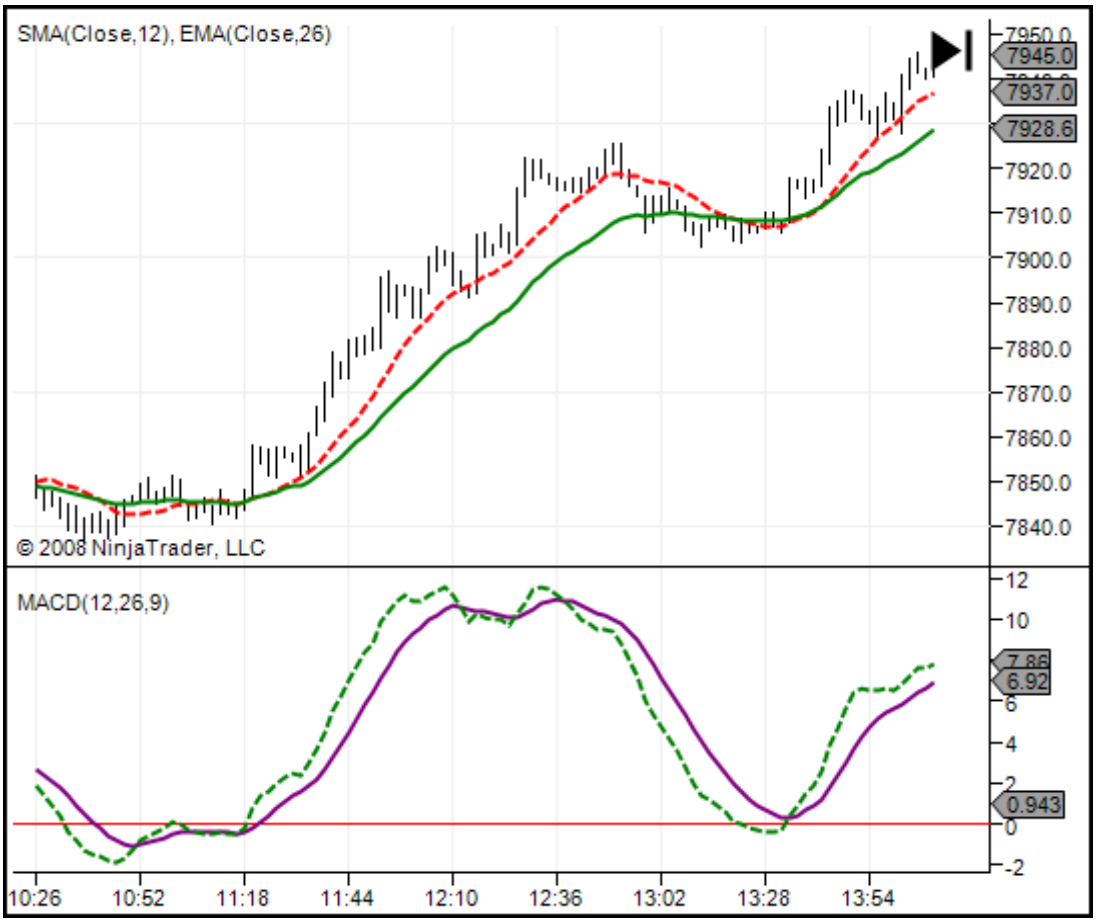
It is this convergence and divergence of the moving averages, and the crossovers, that are shown on the MACD indicator. Let's looks at it again, this time with the moving averages plotted on the price chart too.



Let's consider the dotted line in the bottom section first. This dotted line in the MACD indicator underneath the price chart is measuring the difference between the two moving averages in the price chart.

When the dotted line crosses from below zero to above zero (red horizontal line), this is showing the 12 period moving average rising above the 26 period moving average, which suggests a potential up trend developing. As the price trends strongly higher, the shorter-term moving average follows the price more quickly than does the longer-term average line, and the distance between the two moving average lines grows, which is shown as a rising solid line on the MACD indicator. If the price trend slows (i.e. prices not rising so fast), the two moving averages will start to converge, and the solid line will start to fall. While it remains above zero, the trend as defined by the MACD is up.

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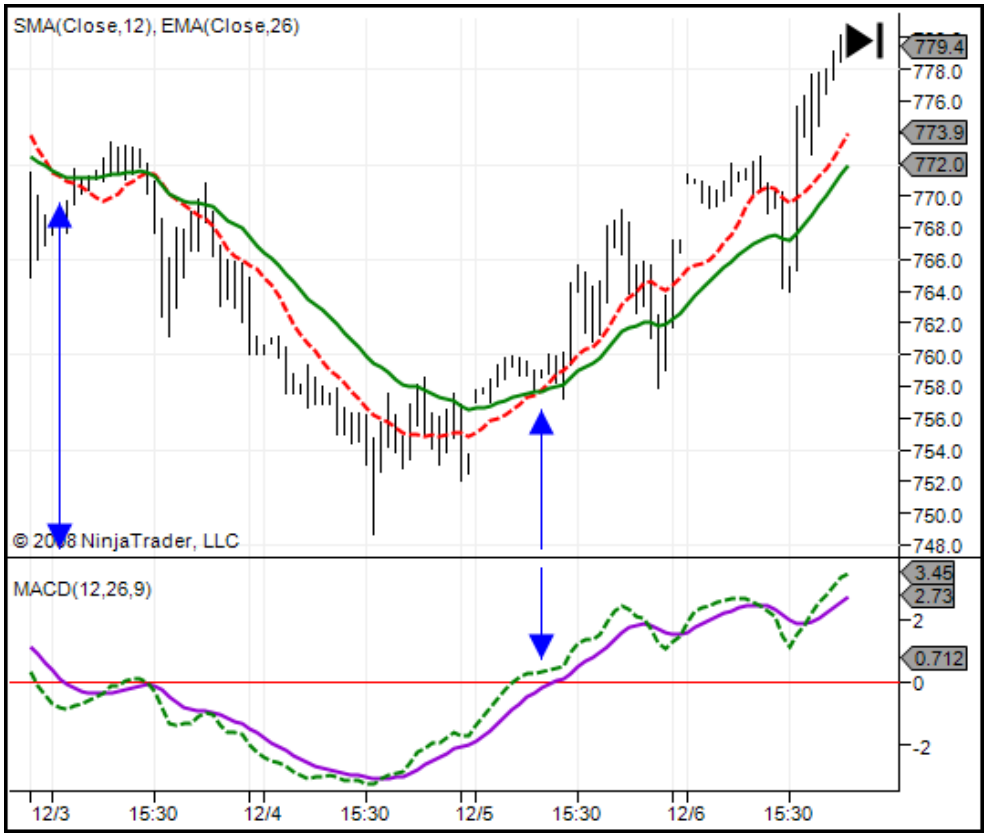
When the solid line crosses from above zero to below zero, this is showing the 12 period moving average falling below the 26 period moving average, which is warning of a potential downtrend developing. A cross from below the zero line to above alerts to a potential uptrend.



If the price trends strongly lower, the shorter-term moving average follows the price more quickly than does the longer-term average line, and the distance between the two moving average lines grows, which is shown as a falling solid line on the MACD indicator. The further the solid line moves away from the zero line, the stronger the current trend. If the price trend slows (i.e. prices not falling so fast), the two moving averages will start to converge, and the solid line will start to rise. While it remains below zero, though, the trend is still defined by the MACD as down.

There is also a solid line in the bottom section of the chart. This line is an early warning line of a potential change in trend. When the dotted line crosses from below the solid line to above, it is a sign of potential rising prices to come. When the dotted line crosses from above the solid line to below it, it is a sign of potential falling prices to come.

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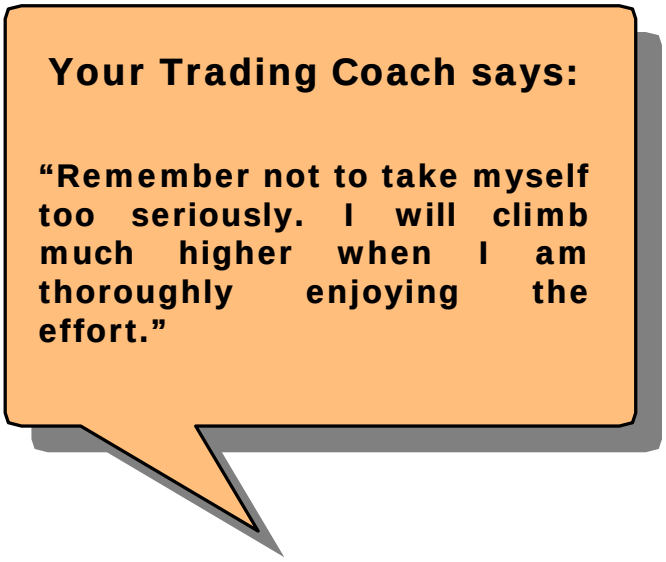
Chapter Eight
Technical Analysis: Oscillators


Your Trading Coach says:
“Remember not to take myself too seriously. I will climb much higher when I am thoroughly enjoying the effort.”

Oscillators

Definition

Oscillators are technical indicators constructed to provide indications if a market is in an overbought or oversold condition.

Oscillators are indicators that vary, or rotate between two extremes, usually around a set level such as zero, or 50, although some are range-bound. The Stochastic, for example, oscillates between 0 and 100. Others, such as the CCI which measures the deviation from the mean, have no boundaries. Both types can be used for divergence setups which will be explained in the section on Trading Methodologies.

Common Oscillators

The following pages show a number of the most common oscillators.

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Momentum Oscillator

Type: Unbound
Description: A simple but effective oscillator. The MO differs from other oscillators, such as Relative Strength Index (RSI) and Stochastics, in that it uses both up and down intraday data in the numerator of the calculation to measure momentum directly. Primarily used to look for extreme overbought and oversold conditions, the MO can also be used to look for trends.
Usage: Divergences, Directional change.

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Average Directional Index

Type: Unbound
Description: The Average Directional Index (ADX) measures the strength of a prevailing trend as well as whether movement exists in the market. The ADX is measured on a scale of 0 - 100. A low ADX value (generally less than 20) can indicate a non-trending market with low volumes. However a cross above 20 may indicate the start of a trend (either up or down). If the ADX is over 40 and begins to fall, it can indicate the slowdown of a current trend.
Usage: Commonly used to confirm trend setups when ADX is above 20 or 30.

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Average True Range (ATR)

Type: Unbound
Description: The Average True Range (ATR) is a measure of volatility. It was introduced by Welles Wilder in his book *New Concepts in Technical Trading Systems*, and has since been used as a component of many indicators and trading systems.
Usage: ATR is very useful both as a volatility measure and also for indicating trend strength. Mostly used in Keltner bands and in volatility-based trailing stops (a trailing stop is a feature of many trading applications which helps you lock in profits.).

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Commodity Channel Index (CCI)

Type: Unbound
Description: The CCI measures the variation of a security's price from its statistical mean. High values show that prices are unusually high compared to average prices whereas low values indicate that prices are unusually low.
Usage: Overbought/oversold levels, divergences, trend line breakouts, zero line bounces.

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Moving Average Convergence Divergence (MACD)

Type: Unbound
Description: The MACD (Moving Average Convergence/Divergence) is a trend following momentum indicator that shows the relationship between two moving averages of prices.
Usage: Overbought/oversold levels, divergences, trend line breakouts, zero line bounces.

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Relative Strength Index (RSI)

Type: Bound (0 – 100)
Description: The Relative Strength Index (RSI) is a price-following oscillator that ranges between 0 and 100.
Usage: Overbought/oversold levels, (usually set at 30 and 70).

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Stochastics (%Ds and %K)

Type: Bound (0 – 100)
Description: The Stochastic Oscillator is made up of two lines that oscillate between a vertical scale of 0 to 100. The %K is the main line and it is drawn as a solid line. The second is the %D line and is a moving average of %K. The %D line is drawn as a dotted line. The Scholastic Oscillator is used as a buy/sell signal generator, buying when fast moves above slow and selling when fast moves below slow.
Usage: Overbought/oversold levels, (usually set at 20 and 80), divergences.

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Williams %R

Type: Bound
Description: The Williams %R is a momentum indicator that is designed to identify overbought and oversold areas in a non-trending market.
Usage: Overbought/oversold levels.

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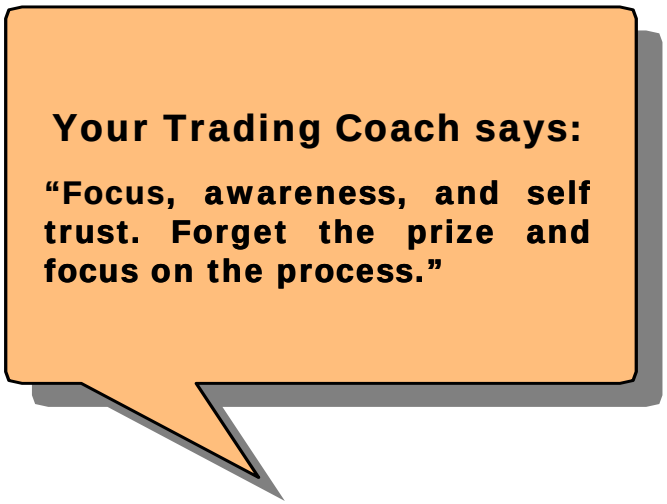
Chapter Nine
Technical Analysis
Swings and Trends



Swings

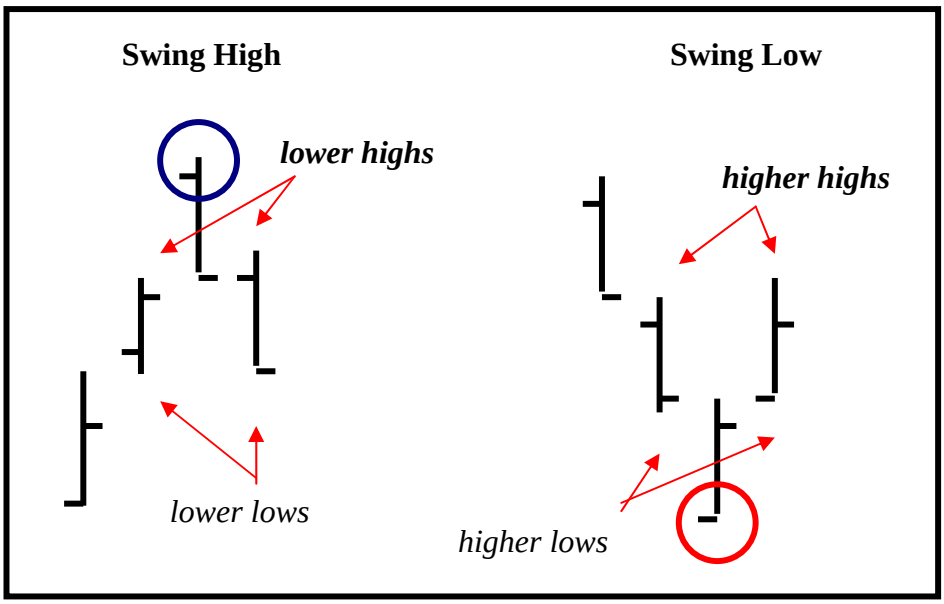
Definition

A swing can be defined as a fluctuation in the value of an asset, liability or account.

A swing high is a point where the market completes an upward move, then falls. It refers to the peak reached by an indicator or an asset's price. A swing high is formed when the high of a price is greater than a given number of highs positioned around it. A swing low is where the market forms a new low before rallying. It refers to the troughs reached by an indicator or an asset's price. A swing low is created when a low is lower than any other point over a given time period.

Swing charts isolate these swings in a graphical format. However, it is easy to identify a swing on bar charts as well.

A swing high will be the high of a bar where the previous bar's high is lower. The following bar's high must also be lower and the following bar's low must be lower than the low of the bar under consideration. A swing low is formed when the previous bar's low is higher, and the following bar's high and low are higher, than the swing bar's high and low. Refer to the diagram below to clarify the concept.



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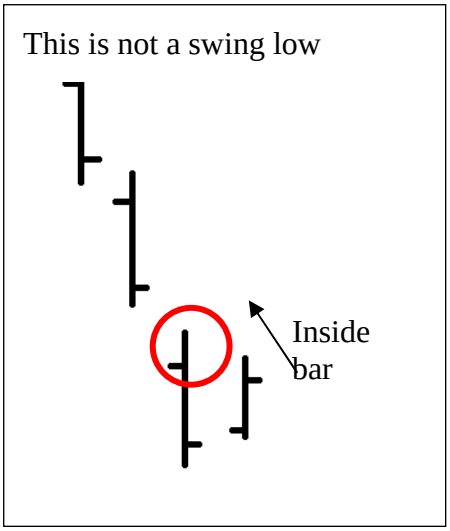
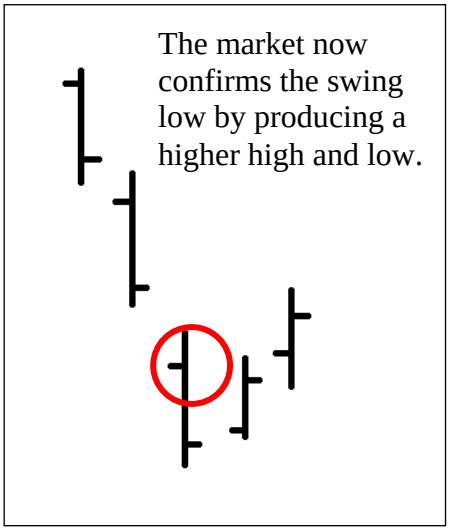
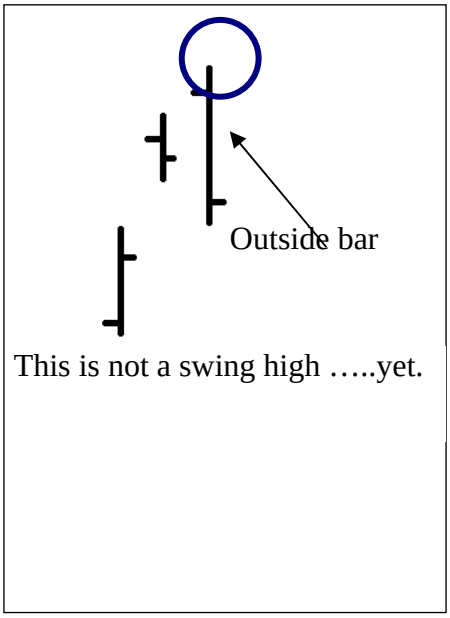
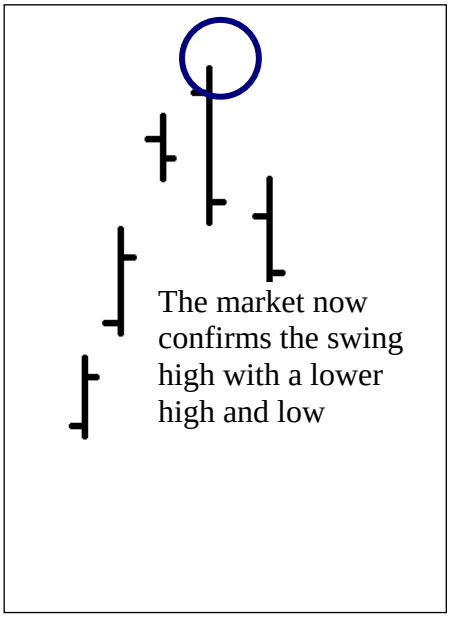
Of course, real charts do not always form such clear patterns as the one shown. Inside and outside bars cause complications. Traders will need to wait at least for one more bar, and sometimes longer, before being able to determine whether a swing has occurred. The two diagrams below demonstrate how to deal with an inside bar.





Outside bars also require confirmation before assuming a swing has occurred.





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In both cases the market could have continued in the original direction, down for the first series and up for the last series of diagrams. If this was the case, then no swing had actually occurred. On some occasions, a series of inside and outside bars may form and so more time is required before identifying a swing. Also, in the case of an inside bar, wait until the suspected swing bar's high or low is broken before assuming a swing.

Common sense is often required. In an upward movement for example, a bar may form that is just a little bit lower on the highs and lows of the previous bar. This then technically confirms the previous bar as a swing high. However, the market may then continue to rally (a period of sustained increases in the prices of stocks, bonds or indexes.) Although technically a small swing high and low have interrupted the up move, for practical trading purposes this interruption has no real meaning. It is best to ignore the interruption and consider the whole move as one leg. A little practice and thought will resolve these issues for the large majority of people.

Now that swings are defined, we are in a position to delve into trends.

Rising Trend

Definition

A rising trend is when a market is exhibiting positive momentum when in a rising or up trend.

This trend is evident on a chart when the swing lows and swing highs are successively higher. Stock markets in particular have a tendency to follow long term rising trends. Markets in an uptrend are called 'bull' markets and feature demand outstripping supply, i.e. there are more buyers in the market than there are sellers. Because of this, prices keep exhausting at higher and higher levels, with only occasional pauses or pullbacks.

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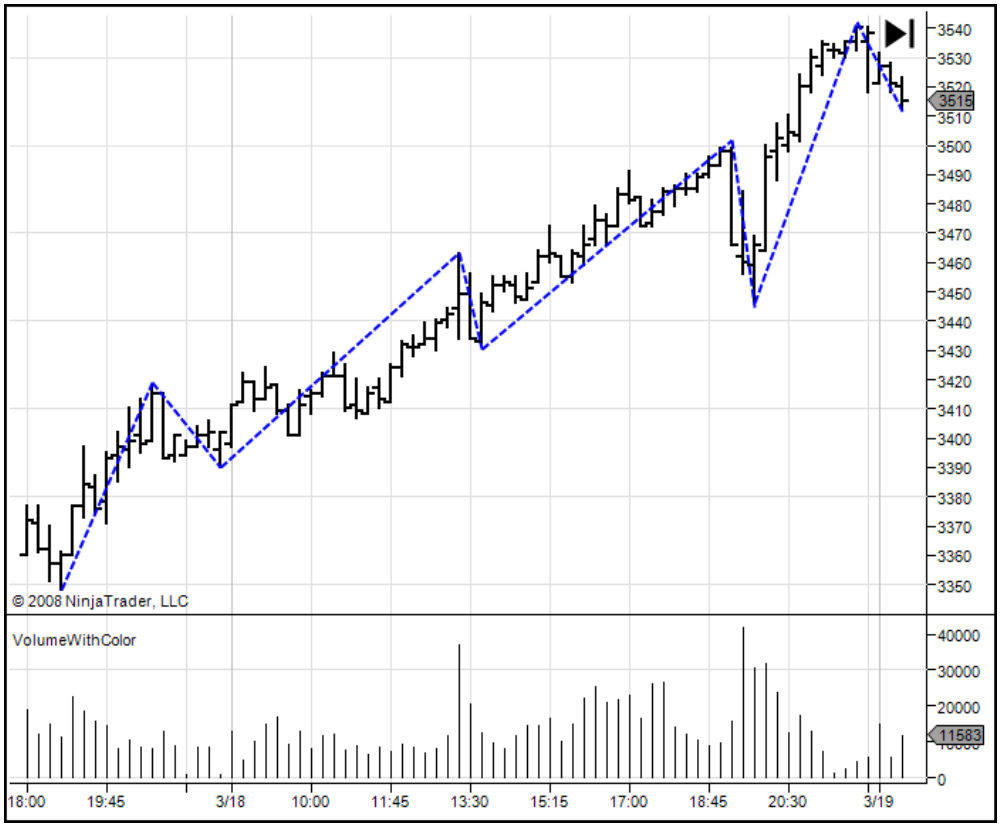
The 15 minute chart below of the DJ EuroSTOXX 50 futures contract demonstrates a clear rising trend. Look closely at the choice of swing highs and lows shown by the dashed blue lines to ensure you have understood the last section on swings.

FESX in a rising trend on a 15 minute chart



Down Trend

Definition

A down trend describes the price movement of a financial asset when the overall direction is downward.

A falling or down trend is the opposite of the uptrend. Successive swing highs and swing lows are formed at lower prices. A market in a down trend is referred to as a 'bear' market and is clearly exhibiting negative momentum. Markets exhibiting this type of chart pattern are often facing some sort of financial difficulty, and/or indicate an oversupply of the underlying instrument. These markets can be driven by fear, with the masses panicking to exit

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unprofitable positions. Because of this, prices keep exhausting at lower and lower levels, with only occasional pauses or retracements. The following 15 minute chart shows the SPI 200 in a down trend.

SPI 200 in a falling trend on a 15 minute chart

Consolidating Markets

Successively higher and lower swing highs and swing lows are not the only possibilities however. Prices can trend in a sideways motion. There are three possibilities: ***horizontal channels***, an ***expanding market***, or a ***contracting consolidation zone***. For the horizontal channel (or consolidation zone), the swing highs form around the same price level. The swing lows also form around a similar price level, which is obviously lower than the price level maintained by swing highs. A contracting market is defined when successive swing highs are lower and successive swing lows are higher. As the name suggests, an expanding market is the opposite. Swing highs are successively higher and swing lows are successively lower. Channels can stay in effect for long periods, however contracting, and particularly expanding markets, do not generally remain in effect for long.

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Accumulation and Distribution

Accumulation

Consolidation areas can be given one of two names, depending upon what happens *after* the market breaks from the zone. If the market breaks upward from a consolidation, then we assume it was an accumulation period. The term originated from stock markets, whereby ***accumulation*** was a period where traders or insiders who were 'in the know' bought or accumulated more stock, although today it applies to all markets and instruments. The insiders accumulate a bigger position at the expense of traders who sell at low prices. Whether prices are actually low or not is difficult to determine at the time. This is why insiders are considered the ones who accumulate (though it may not necessarily happen that way). Accumulation zones often occur after a prolonged down trend.

Distribution

Distribution is the opposite. After a strong up trend, it is assumed that insiders recognise the high prices and seek to gradually sell their position. The traders who are 'in the know' are likely to distribute to the public, who are attracted by the strong price performance. This selling may not only be activated by those who had previously accumulated positions, but also by short sellers who will enter the market at relatively high prices. These traders will later cover their short positions once the retail traders have jumped on the wagon and driven prices down. By doing so, they are able to manufacture significant profits by buying back the undervalued security. It is surprising how often people are attracted to the market at the peak because of the rumours of high profits (of course the profits are being taken by traders who bought much earlier). Experienced and competent traders are selling to novices during consolidation periods that form at high prices. The difficult question is to determine whether prices really are high, or whether the market is accumulating for another run up.

As a trader who is not on the inside of the business, it is difficult to tell whether the consolidation zone is an accumulation or distribution at the time it is forming. However, once the price breaks we can make some reasonable assumptions. If prices run up, assume it was an accumulation. If prices run down, then it must have been a distribution.

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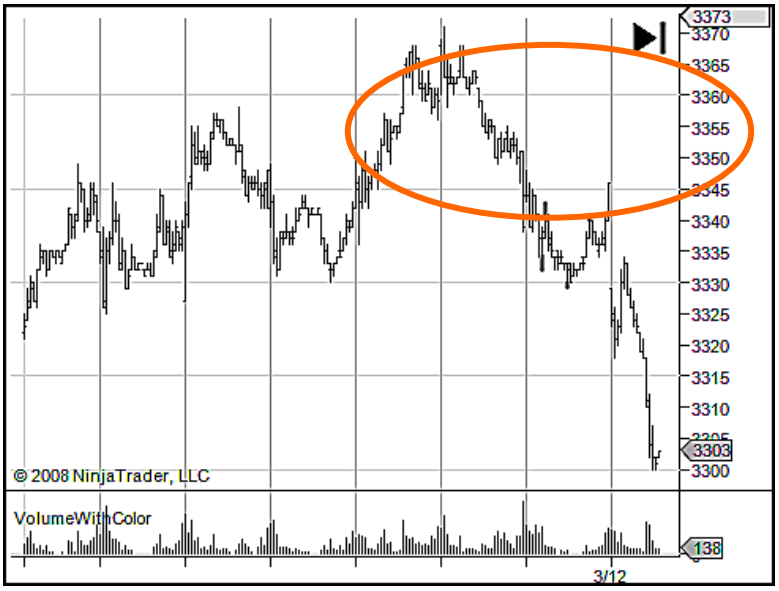
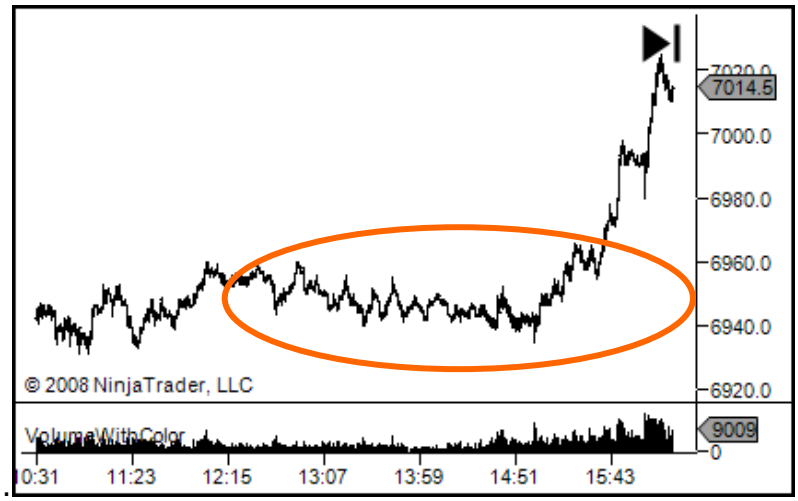
The chart below demonstrates a long-term distribution zone on the SPI 200. The contract ultimately fell by over 60% from the highs.



The one minute chart of the German DAX futures contract (below) demonstrates how accumulation can occur on very short term time frames. The general rule is that the longer the accumulation, the greater the potential for future price growth.



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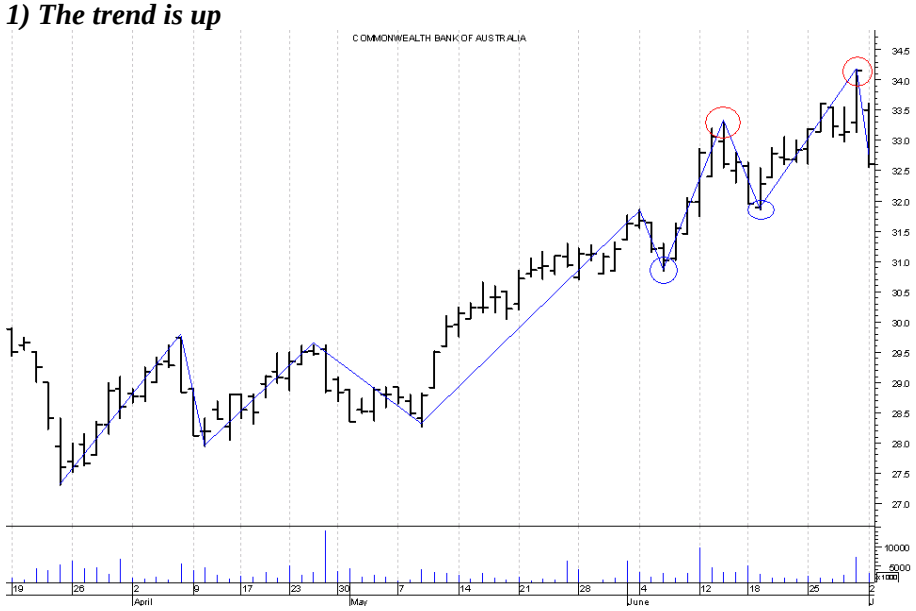
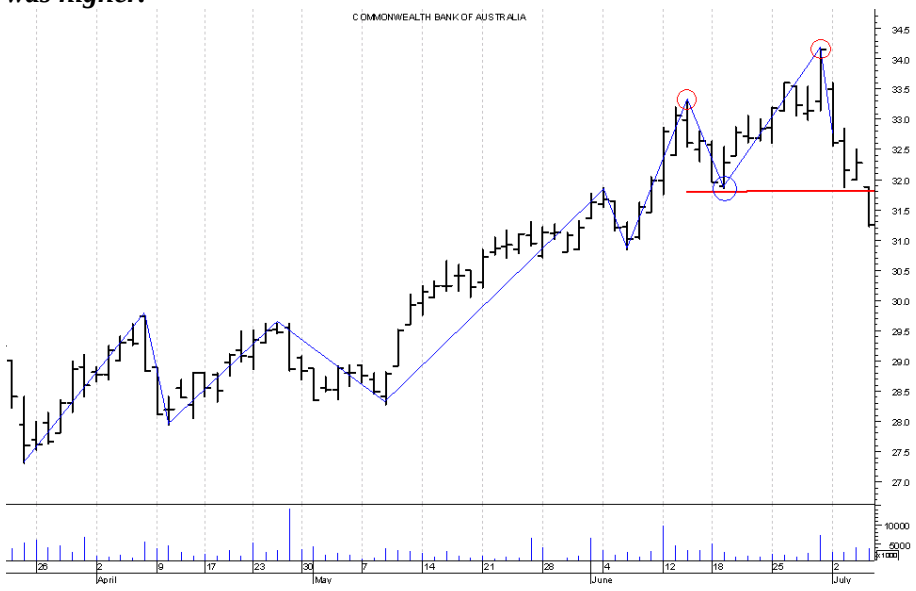
Change of Trend

Although markets exhibit some momentum characteristics, the trend does naturally change. Markets will change from rising to falling trends and vice versa, sometimes by passing through some sort of consolidation movement. The important point to consider here is to be careful not to assume too much. This is avoided by understanding when a change of trend has been 'confirmed'. The basic requirement is that a confirmed ***down trend***, for example, needs *two* swing lows and *two* swing highs, the latest being lower in both cases. The illustrations below demonstrate these concepts.

1) The trend is up



2) The trend is no longer up since the latest bar has broken the most recent swing low. The trend is not down either because the most recent swing high was higher.



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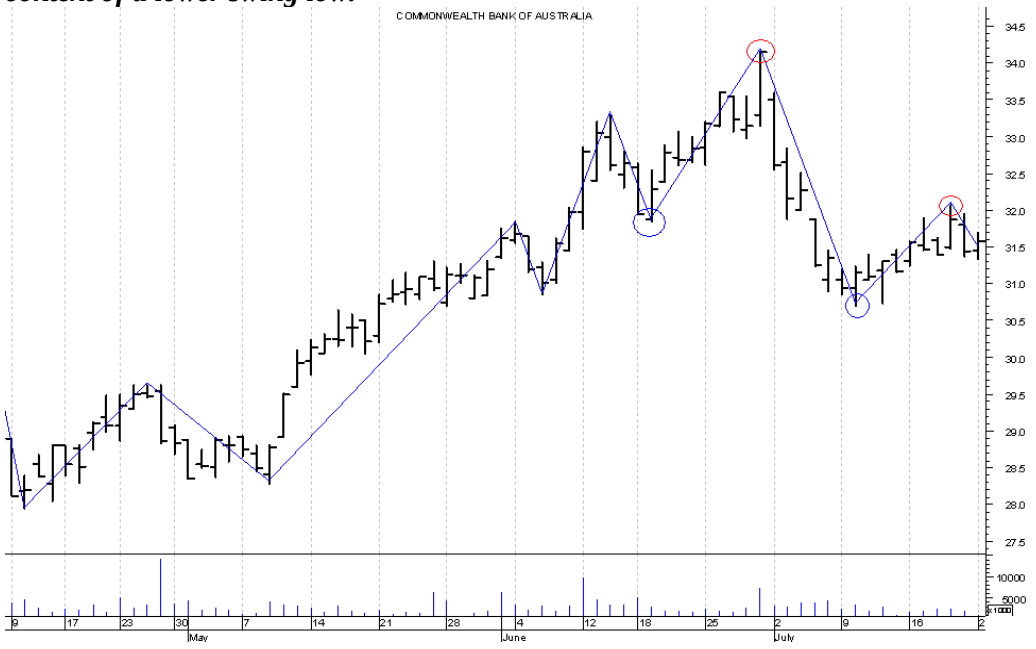
3) The trend is now 'confirmed' down since we have a lower swing high in the context of a lower swing low.



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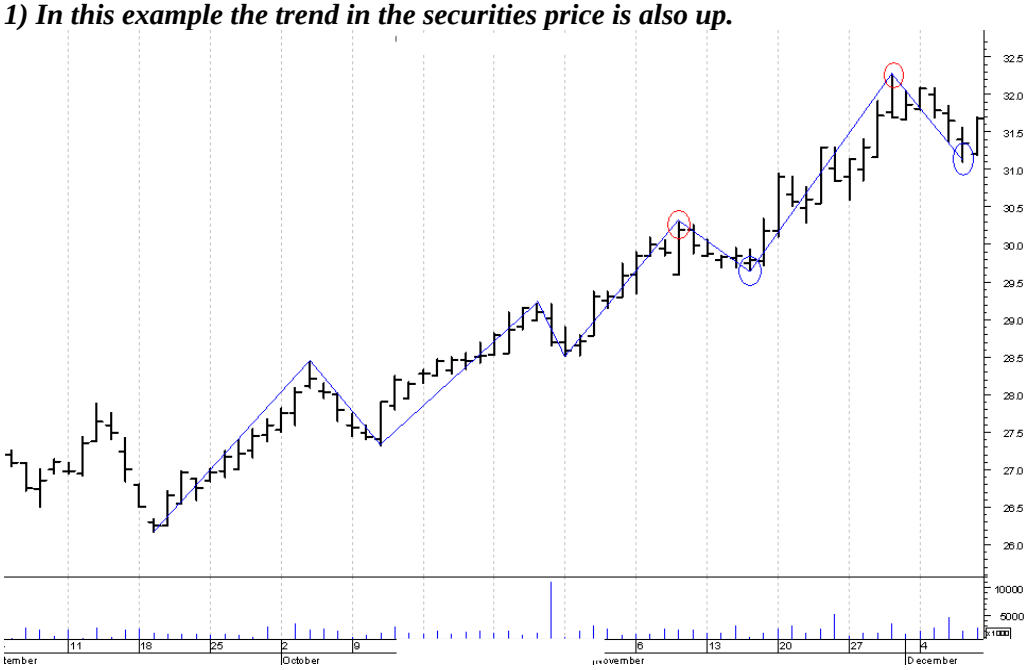
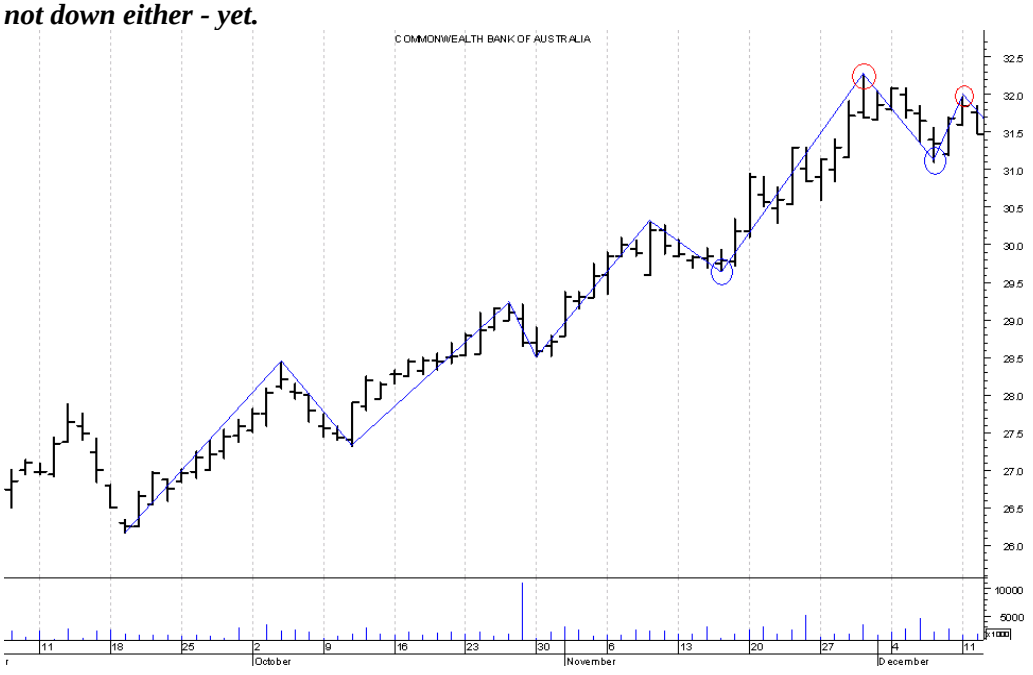
1) In this example the trend in the securities price is also up.



2) The security has now formed a lower swing high, so the trend is no longer up. It is not down either - yet.



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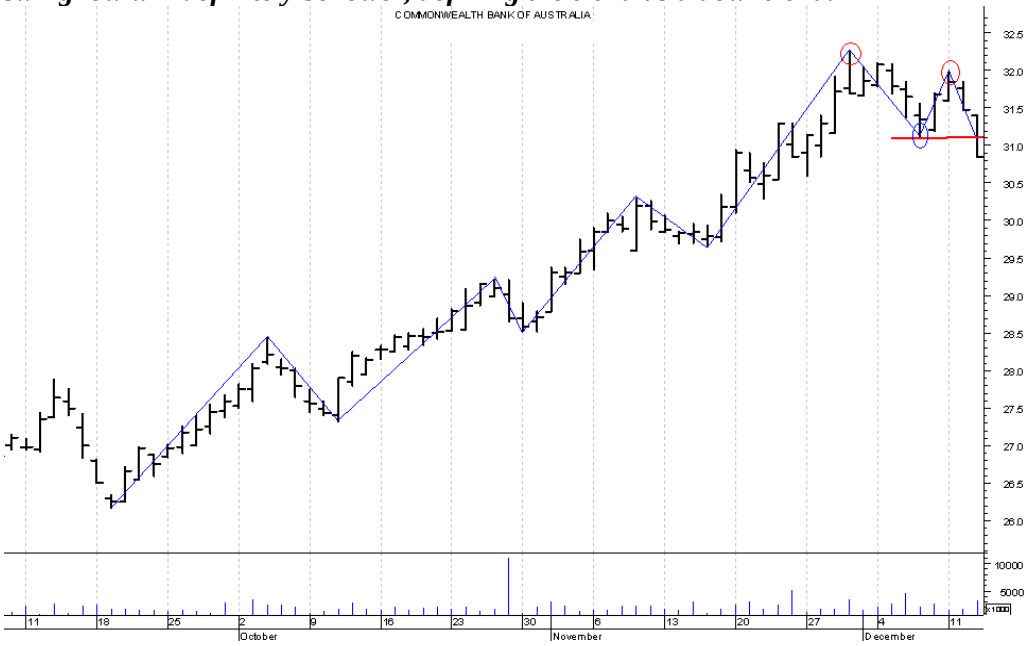
3) The trend is now down. Although we do not actually have a lower swing low, the most recent swing low has been broken to the downside. Consequently the future swing low will definitely be lower, defining the trend as a downtrend.



There are better, and more definitive, methods for determining the trend in real time. At present, however, we are concerned with being able to identify the trend on a chart, which clearly offers the benefit of hindsight. Naturally though, one must be able to spot something with hindsight before foresight should be attempted.

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Support and Resistance

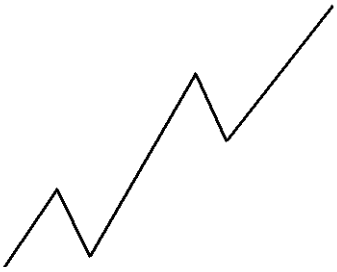
Definition

A **support level** is a price level where the price tends to find support as it is going down. This means the price is more likely to "bounce" off this level rather than break through it. However, once the price has passed this level, even by a small amount, it is likely to continue dropping until it finds another support level.

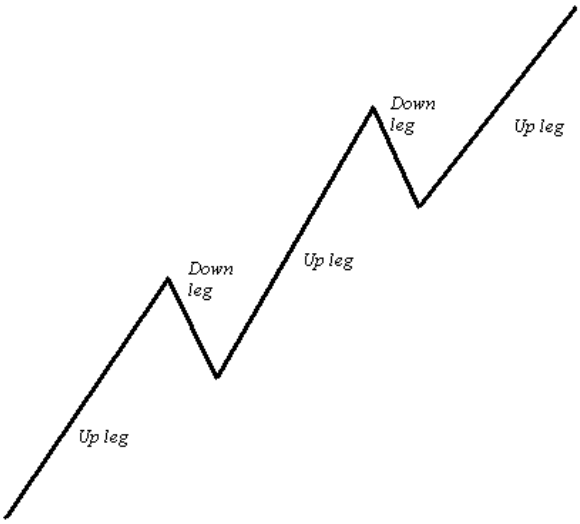
A **resistance level** is the opposite of a support level. It is where the price tends to find resistance as it is going up. This means the price is more likely to "bounce" off this level rather than break through it. However, once the price has passed this level, even by a small amount, it is likely that it will continue rising until it finds another resistance level.

Let's leave 'swings' now and look at another phenomenon displayed on price charts that is of interest to traders – ***support*** and ***resistance.***

As a trend develops (let's use an uptrend as an example), prices rise and fall back, rise and fall back and so on. We could summarise a stylised up trend in a diagram like this:



This is obviously a very simplistic representation of an uptrend. The price bars are not present, so much of the detail of price activity is missing; all we have is a representation of the up legs and down legs with a solid line.



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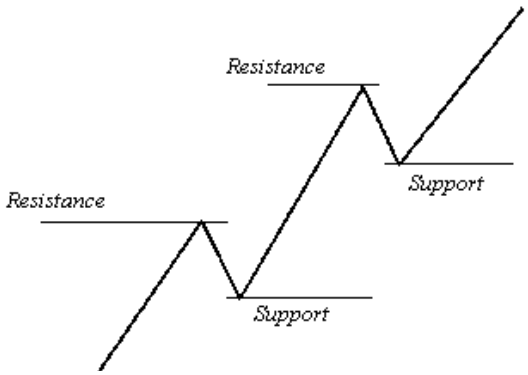
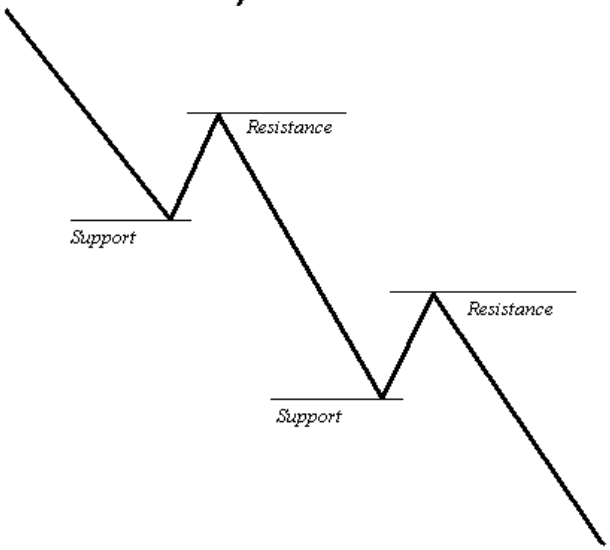
As the prices move up, a series of peaks and troughs are created. These peaks and troughs are labelled resistance and support:

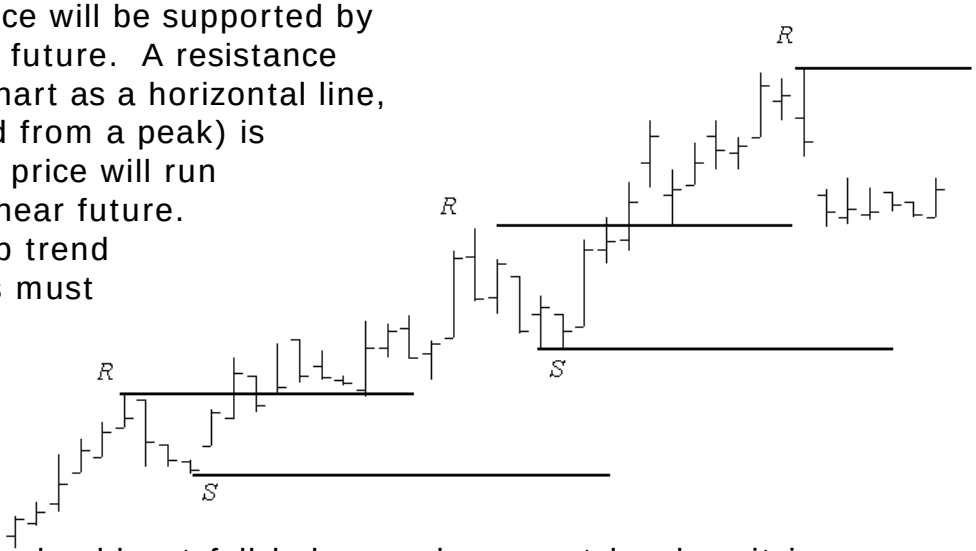


Similarly in a down trend:

Note that support is formed when the price forms a trough; resistance is formed when the price forms a peak.



Below is an uptrend example. Support and resistance are marked with an "S" and "R" respectively. Support and resistance lines are projected to the right on the chart. A support line (on the chart as a horizontal line projected from a trough) is an area where the price will be supported by buying in the near future. A resistance line (also on the chart as a horizontal line, this time projected from a peak) is an area where the price will run into selling in the near future. Note that for an up trend to continue, prices must exceed previous resistance levels.



In addition, prices should not fall below each support level as it is formed.

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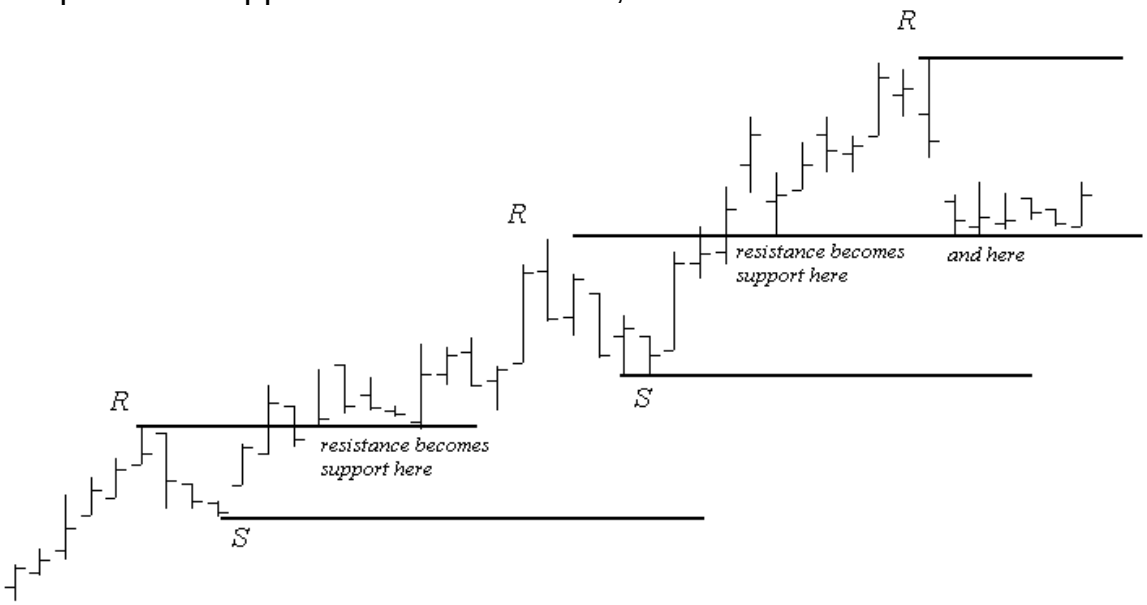
It is important to note that the horizontal lines projected from the peaks and troughs are projected *to the right, into the future*, so as to provide an indication for the important points to watch as the uptrend develops.

Note also the fact that once resistance is breached it can then act as a support level for future price developments. For example, the horizontal line projected from our first "R" provides a base for prices around one to two weeks later. The line projected from the second "R" provides support on two occasions, thus:



Support and resistance levels also form around what are referred to as ***consolidation zones***. A consolidation zone is an area where the price gets "stuck" within a narrow range. Consolidation zones are difficult to describe in words; a few examples are probably the easiest way to understand what is meant.

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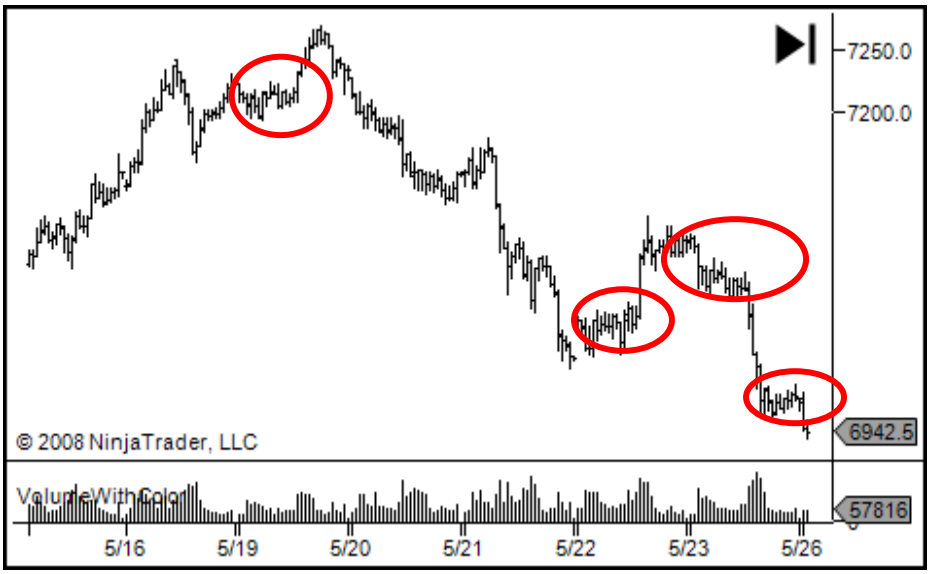
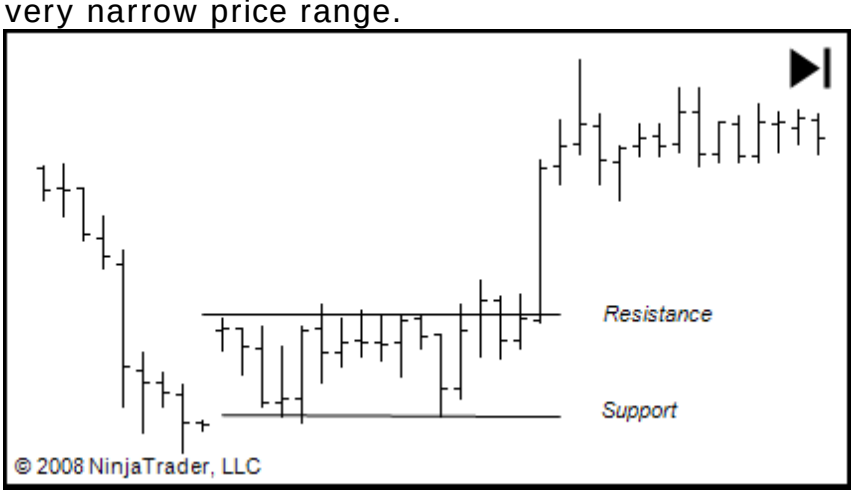


The FDAX shows quite active price behaviour in this 30 minute chart, but is interspersed with periods where prices get "stuck" in a very narrow price range.



Zooming in to this area shows how the price gets caught between two price levels for a period of about 8 hours. This price area is the consolidation zone, and we have labelled the upper boundary the resistance line, and the lower boundary the support line. Note that price pierced the resistance line in the middle of the consolidation area, but still closed back well below the resistance line.

A consolidation zone may last for any period of time. Keep in mind that one of the characteristics of a consolidation zone is that it is a time when prices display lower than characteristic volatility. Being able to "see" a consolidation zone takes practice, and can often be a subjective decision.

Two examples are shown below. The first is a 5 minute chart of the emini S&P 500 on the 19 March 2008 where price traded in a tight

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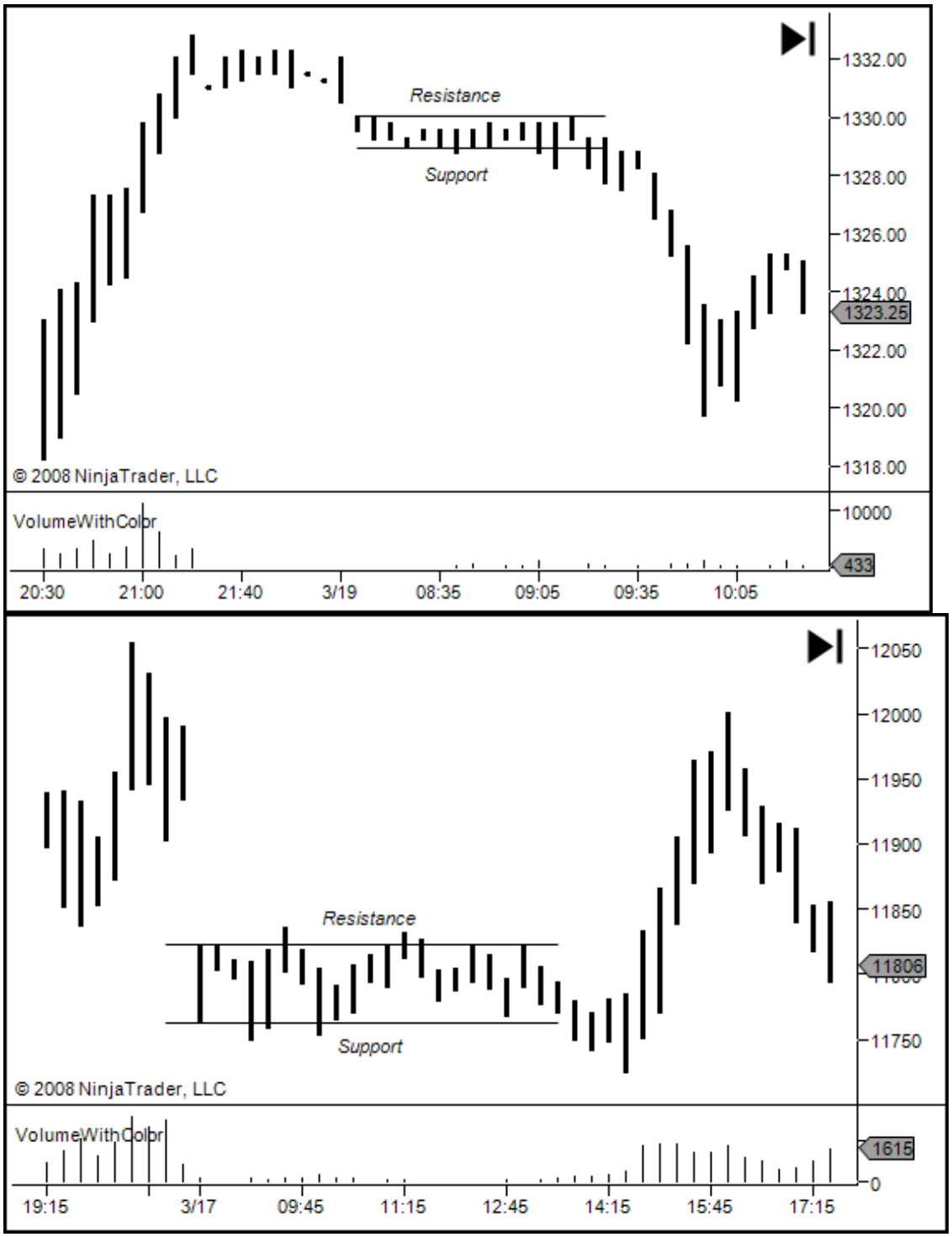
range for over an hour, and the second shows a 15 minute chart of the March 2008 Dow mini contract, where price traded in a relatively narrow band (for the Dow) for over 5 hours.



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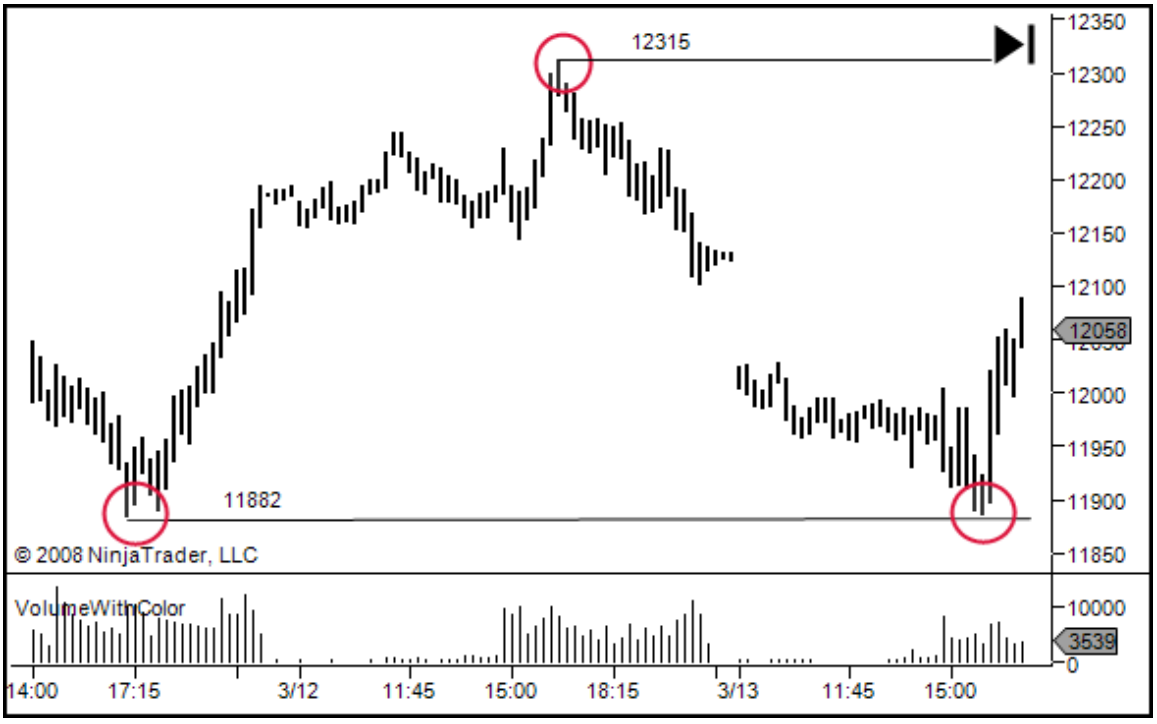
Trend Lines

Definition

Trend lines are the support and resistance lines that provide the boundaries for consolidation.

In the case of the support and resistance lines bounding the consolidation zone examples we have just seen, these are short term trend lines, and all are horizontal. Trend lines need not be horizontal, but we will come to these sloping trend lines in a moment.

Support and resistance trend lines can also be seen on longer term price charts. The more price reaction a peak or trough elicits, the greater the importance and significance of the resistance or support line that is projected from it. What this means is that if price has reacted a great deal from a peak or trough (i.e. moved a long way in price) then this price level at the peak or trough should elicit a further significant price reaction the next time the price approaches this level. Again, some examples are probably the best way to understand this phenomenon.



On the 11 March 2008, the Dow mini contract made a trough at 11882, whereupon prices traded up to a high of 12316 late the following day – a total of 433 points, or 3.65%. The 11882 price level thus became very significant, and when prices approached it

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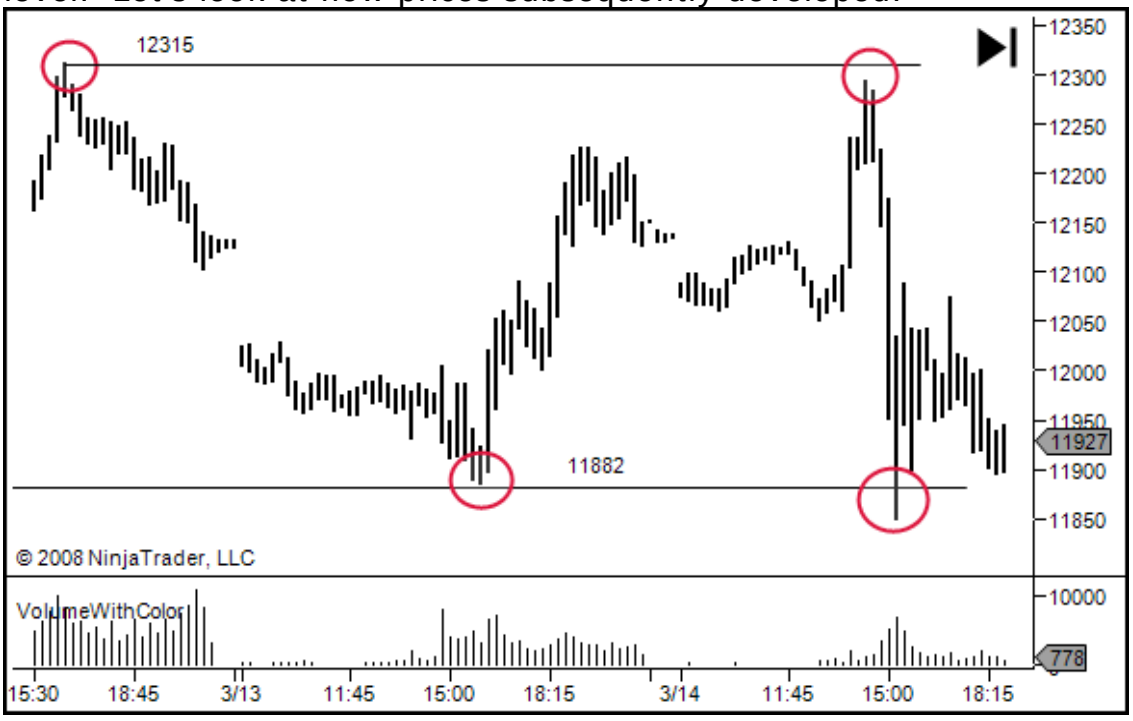
late on the 13 March, this level acted as significant support, reversing the downward trend.

The 12315 level was also now established as a significant resistance level. Let's look at how prices subsequently developed.



Again, on the 14 March, price found significant resistance close to the 12315 level, and although it penetrated support at the 11882 level, price quickly rallied above the level.

Does this mean that the 12315 and 11882 price levels were really not of any significance and this idea of long term support and resistance is irrelevant to real world trading? Not at all. These long term support and resistance points should not be considered specific levels, accurate to the point. Allowances must be made if these price points were made a long time ago. Long-term support and resistance, such as what we have examined in the YM chart above, should be viewed as 'zones' of support and resistance, not just one, specific level. When the time comes to make actual trading decisions, requiring that precise points at which to buy or sell be identified, other tools need to be used simultaneously. Trend line support and resistance provide the context within which to make decisions, but not necessarily the right tool to make the actual decisions.

Trend lines need not be horizontal. More often than not, the trend lines used by technical analysts are not horizontal, but slope in one

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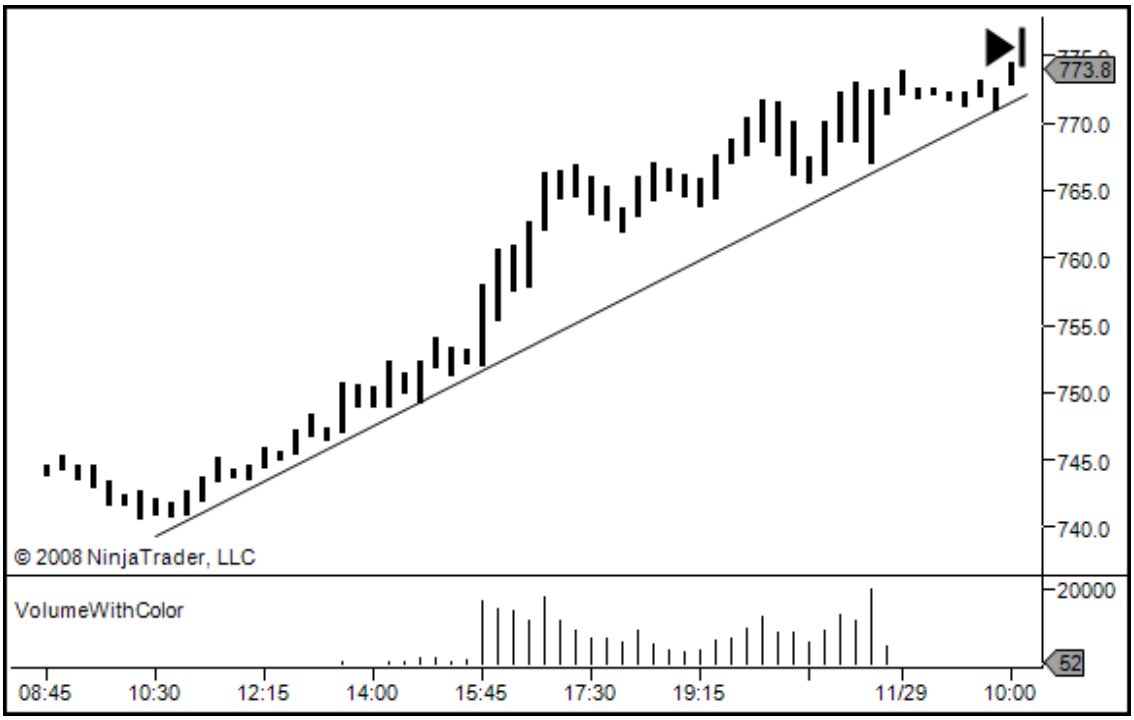
direction or another to help delineate an up or down trend. Trend lines can be used in this way to help delineate both short term and long term trends.

Here is an example up trend line for the Russell 2000 for the December 2007 contract.



There are almost as many ways of defining how to draw a correct trend line as there are technical analysts. The above line is drawn according to "classical" principles: that is the line begins at the lowest point from which the uptrend began (the low at about 10:30 on the 28 November 2007) and run through a point at about 10:45 the following day where price breaks the line and starts to fall. As can be seen, price has rebounded and returned to the line numerous times throughout the day, but once a significant breach occurred, combined with a close below the line, this defined the end of the uptrend.

Here is something to be aware of. Once the uptrend line ceases to function as the uptrend line, it is still of use! The line should be projected to the right on the chart, and note taken if prices come back up to touch the line again (obviously this time the price will approach the line from below). This is where our "support becomes resistance" rule can be of use – that is an old support line can become a new resistance line.

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This mini Dow trend line is a very “neat” example, but we need to recognise that not many trend lines are quite as neat. One of the complicating factors that can make trend line drawing complicated is that trend lines will often need to be redrawn as a trend progresses, sometimes with a steeper line, and sometimes with a shallower line. Another complicating factor is that while a price trend is sometimes obvious, it is sometimes not possible to draw in a trend line that describes it. We will consider each of these complicating factors.

Before we go on to look at when and how to redraw trend lines, we need to spend just a moment discussing what it means for a trend line to be ‘steep’. The steepness of a trend line refers to the angle at which it is drawn. But it is really not possible to say absolutely if a trend line is steep or not, because the slope of the line can be affected by the scale at which the chart is drawn. A trend line can be made steeper by simply including more price data on the chart; have a look at these two different trend lines:

The trend line on the left is clearly steeper than the trend line on the right; it is at a much greater angle, showing prices moving up more rapidly than on the chart on the right. This is not true, of course. These are both actually the same chart, with the same trend line, drawn at different scales. Both charts are of the same instrument (in this case Billabong shares), and the trend line on the left is only steeper because of the scale change.

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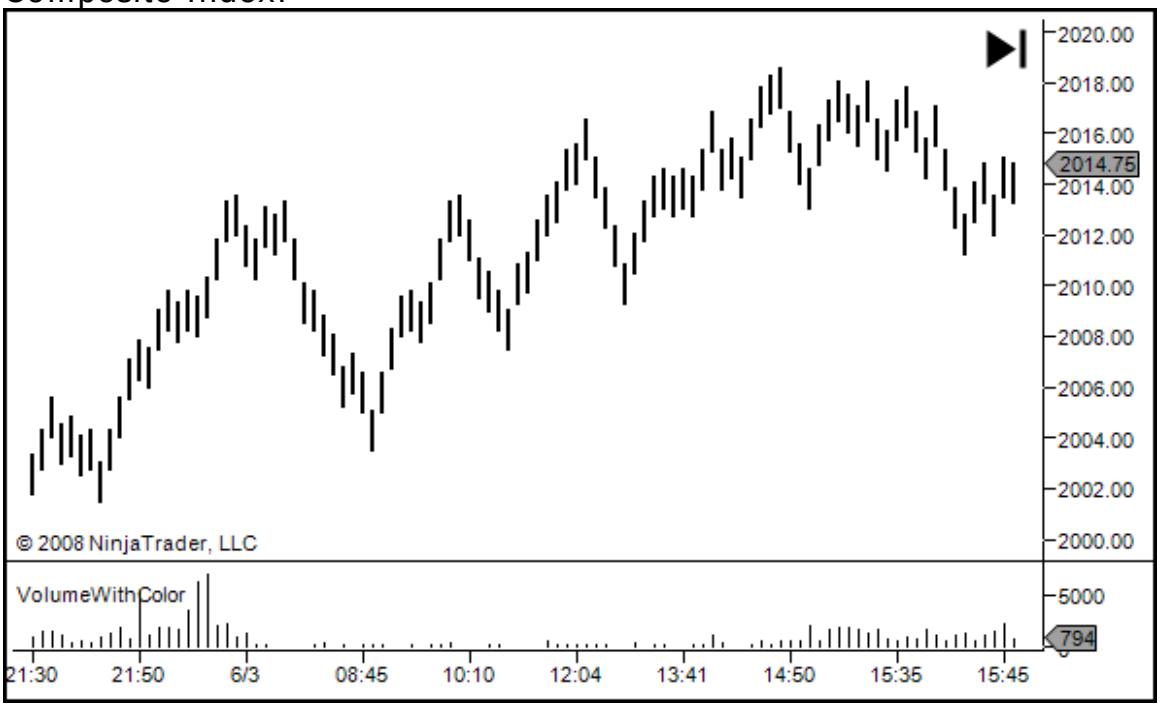
Thus steepness of the line cannot be considered in isolation from the scale. The fact remains, though, that sometimes price moves up very rapidly, and such price movement would be better described by drawing a steeper line. It is important to understand that the steepness of a trend line is a relative term.

See below for an example of an uptrend on the emini Nasdaq Composite Index.



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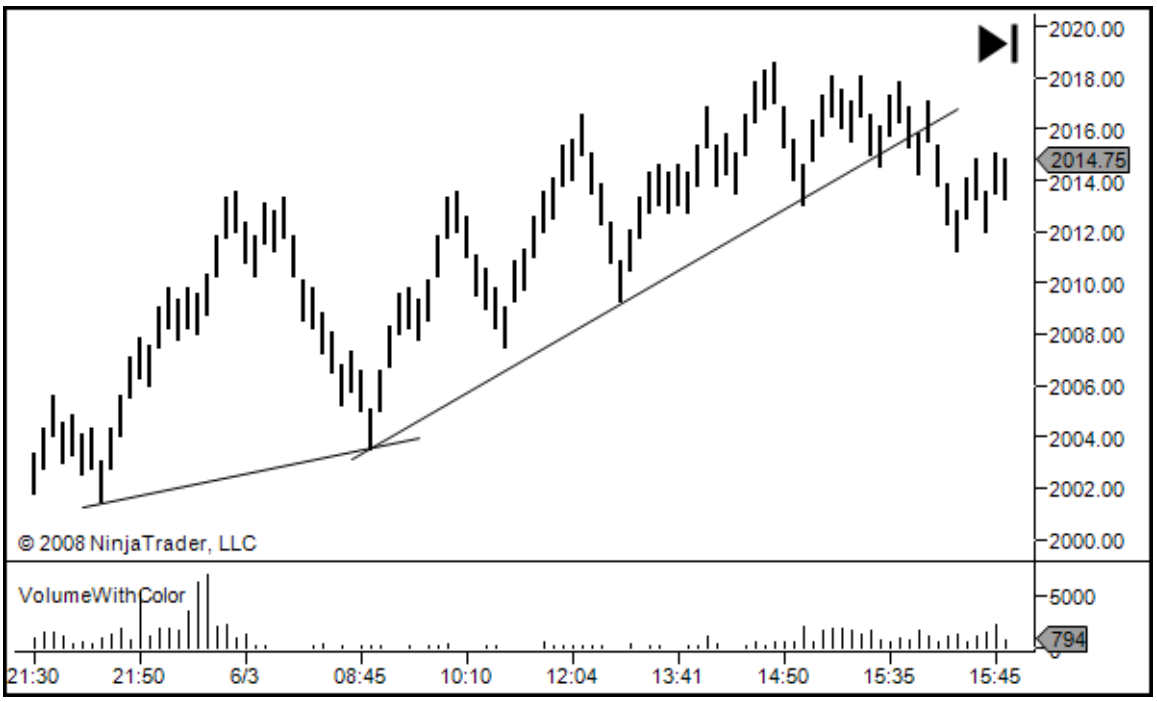
Let's draw in our first trend line;

Note that this initial attempt at drawing in a trend line fails because a trend line needs three points, and here we have only the first two (the first in mid-September, the second in early October). Let's try another trend line:



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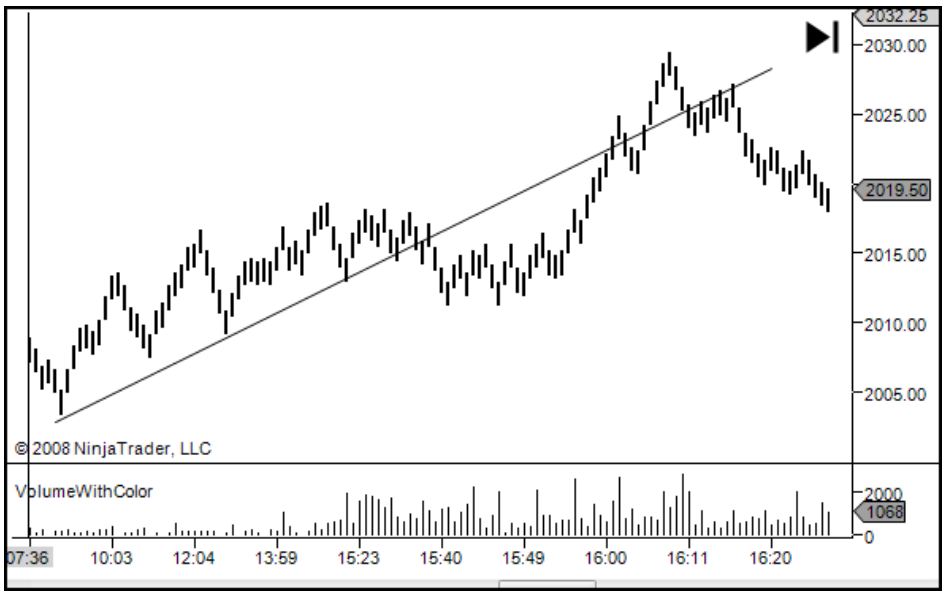
This trend line is better as we have three defining points. The third point on the trend line confirms that it is, in fact, a trend line. A trend line with only two points is a potential trend line.

A trend line should, ideally, begin at the initiating point of the trend, but when trend lines need to be redrawn to account for subsequent price movement, as must be done here, they often cannot begin at this initiating point. The next best alternative is to draw the trend line from an obvious low point in the trend (termed a **reaction low**).

How useful are trend lines? Take the second line we have just drawn in. By the time the third point is made, and the trend line confirmed, the price never comes back to touch the line again to set up a potential buy point. That is, by the time the trend line is confirmed as existing, by drawing in a trend line, at least in this example, its use as a potential buying area is pretty much passed! This is often a problem with using trend lines to help a trader buy into an existing trend.

Remember though, trend lines have other uses, which are often even more important than their use in defining a trend. They help define when an uptrend is over; by a clear price break of, and a close below, the line. They also act as future resistance points. In our NASDAQ example the uptrend finishes around 15:40, when we see a clear break, and closes below our second trend line. Around 16:00 the old up trend line became a new resistance line, and although it's penetrated a couple of times, price eventually gives up and falls away.



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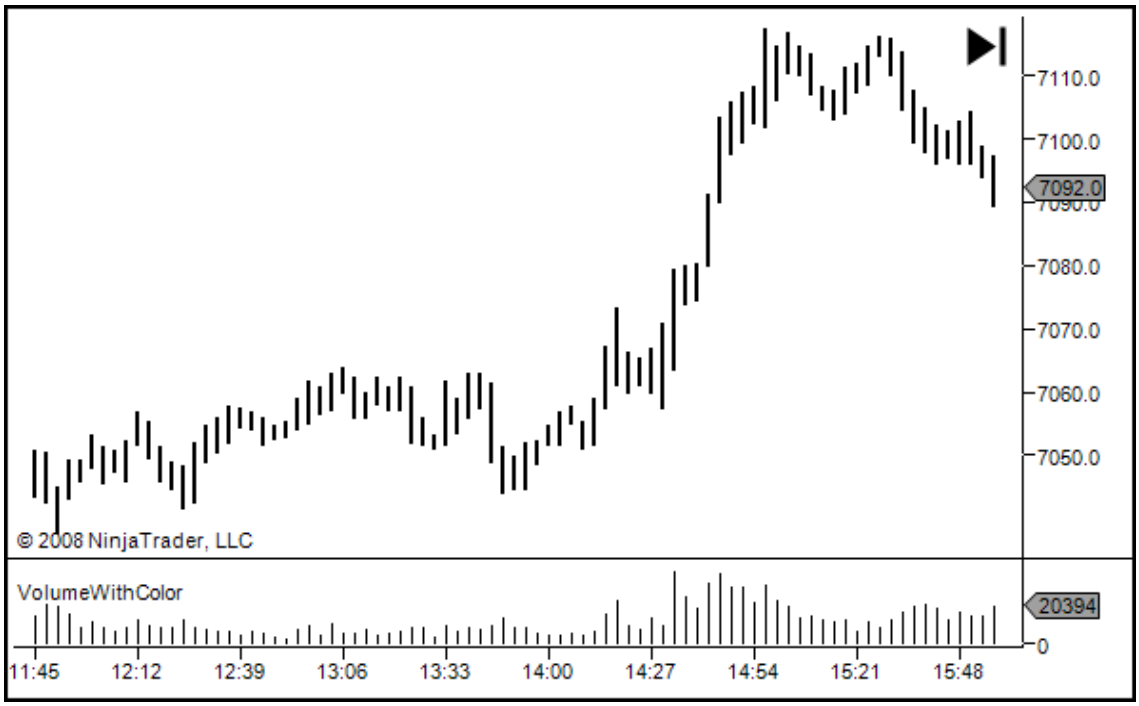
Sometimes it is not possible to draw in a trend line, even though an uptrend is obvious.



Consider the area around 14:30 when the FDAX rapidly appreciated in price from around 7057.5 to 7117.5 in the space of just 27 minutes. Describing this rapid move with a trend line would really make no sense, despite it being a very sharp up trend. Other tools would need to be used.

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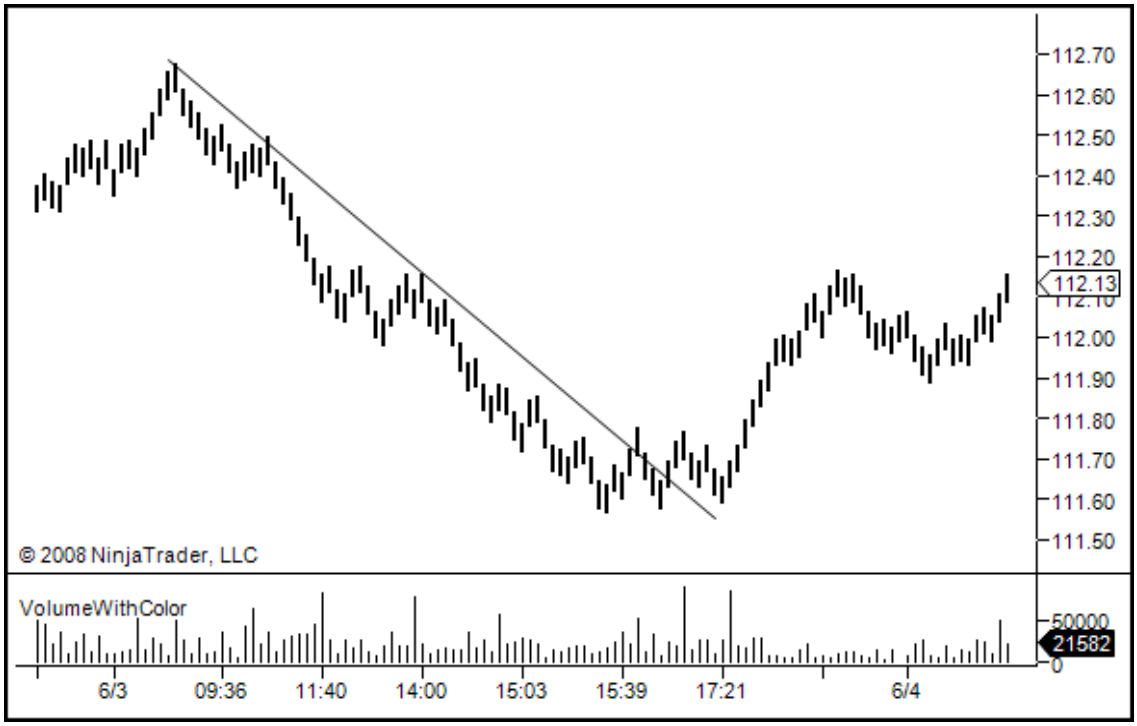
Our analysis of uptrend lines can also be applied to downtrends, with all the rules we have discussed obviously inverted. A down trend line for the Euro Bund Future can be seen below.



The three defining points on the down trend line come around 8:15, 11:00, and 14:30. The initial break of the trend line came around 16:00, closed back below before making a final thrust back through and closing above, signalling the end of the downtrend.

Trend lines are one of a few useful ways of defining trends.

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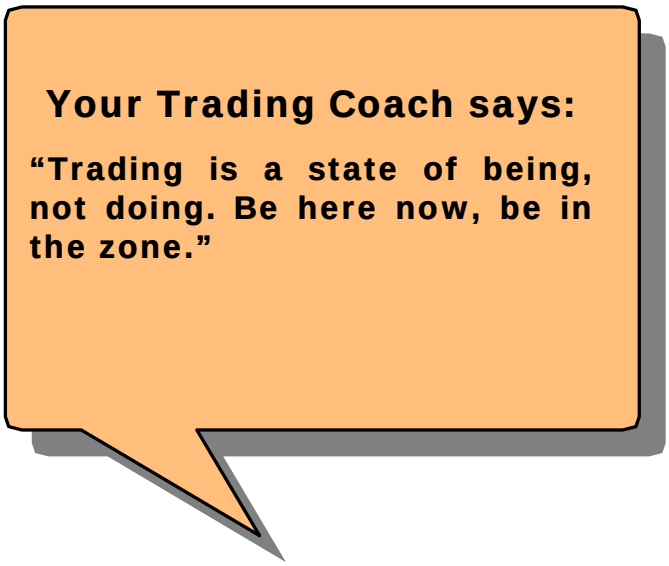
Chapter Ten
Trading Methodologies



Trading Methodologies

The Your Trading Room team are experts in the trading arena and are aware of the crucial mistakes traders, both experienced and inexperienced, commonly make.

Our clients are privy to these "insider's" tips and pointers, and receive both initial and ongoing advice from our coaches.

However, for the first time, we have made this information available to traders outside of our client base, and are pleased to share with you in this chapter, tips and trading methodologies from our systems that allow our clients to find success through day trading.

Tip One

Remember that there are no open positions at the end of the day.

When working under our trading systems, the first thing to be aware of is that our systems are day trading systems. This is relevant to you because it means that *no open positions are held after completion of the day's trading session.*

Therefore, the trader must hold no open positions – all positions are flat by the end of the day.

Tip Two

Stop Losses are Crucial to Success – Use Them!

Definition

A stop loss is a price threshold that triggers the exit of a position when reached.

We simply cannot stress enough the importance of using stop losses in futures trading. Stop losses must be executed ruthlessly, if and when the time comes to do so. The leveraged risks involved with trading futures can translate into large losses; losses that can exceed one's margin deposit but which a trader will nevertheless be liable for, should they be incurred.

We advise all of our clients to make use of the automatic stop loss facilities offered by futures brokers.

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Tip Three
Our Systems Trade Active, Liquid Markets
Our systems are designed to trade active, liquid markets where executions can be confirmed within seconds. In practice these systems are used to trade the day sessions, i.e. 8.30am to 3.15pm Chicago time of the computer-matched share price index contracts such as the E-mini Russell 2000 Futures and the E-mini S&P 500 Futures, and 8:00am to 10:00pm Frankfurt time of the FDAX and DJ EuroSTOXX 50 Futures contracts.

Tip Four
Our Systems Trade the Closest Contract Month
At the time of writing, all of the futures contracts traded in yourtradingroom.com are based on a March/June/September/December cycle (H, M, U, Z). So, for example, if today's date is April 15 we will be trading the June contract (June being the next month in the cycle). At the expiry of a contract, which occurs every three months, we roll over to the following contract.

Tip Five
The Contract Rollover Day can vary
Contract rollover day varies between instruments. Always refer to the online trading calendar at the relevant exchange.

Tip Six
Understanding Codes
All futures contracts are designated a code by their exchange, as are expiry months.

1. The code for the E-mini S&P 500 Futures contract is ES.
2. The code for the DJ EuroSTOXX 50 Futures contract is FESX.
3. The code for March is H.
4. The code for June is M.
5. The code for September is U.
6. The code for December is Z.

Although many trading platforms require the use of the contract month code, NinjaTrader only requires the contract's exchange symbol, and the month and year. For example, the symbol for the DJ EuroSTOXX 50 September 08 contract is FESX 09-08. The E-Mini S&P 500 March 09 contract is ES 03-09.

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Trading Journal

Traders are strongly advised to keep a trading journal of all trades made. Keeping a trading journal is an essential discipline for a trader. A trading journal is more than a mere tracking tool; it needs to include all information such as:

- entry price;
- number of contracts traded;
- exit prices;
- strategy employed;
- equity curves for each strategy;
- screenshots of each setup, if possible.

Information such as the above, recorded in a journal, will assist the trader to learn and grow in their trading ability. Memory alone cannot be relied upon; facts recorded on paper (or in some other medium, such as your PC) leave less room for creative interpretation after the event.

Selecting a broker

Your Trading Room has researched many brokers for quality service, reliable data and competitive brokerage rates. We advise our clients; refer to our website for further information about our recommended brokers. There are many qualified and experienced brokers available in the US and Australia who will be happy to transact your business.

Understanding risk control

The underlying principle of risk control is to only risk a small percentage of one's trading capital on any one trade.

Risk NO MORE than 2% of trading capital on any single trade.

We advise our clients to risk less than 2% of trading capital.

What this means is that if the worst-case scenario stop loss is executed on a trade, the trader loses no more than 2% of his or her trading account. Risk is controlled by limiting the number of contracts purchased for any trade. Note; risks lower than 2% of the trading account is sensible as trading capital grows.

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How does this principle work in practice?

Let's say our trader has 20,000€ (euros) in trading capital. So the maximum amount of risk to take on any trade is 2% of 20,000€, which is 400€.

Let's say our trader receives a buy signal in the EuroSTOXX 50 Futures contract at 3450, with a stop loss at 3440.

This is a risk of 10 point so the risk per contract on this signal is 10 times 10€, or 100€.

In order to keep the risk below 100€, the maximum number of contracts our trader can trade is four EuroSTOXX 50 Futures contracts on this signal with the 10 point stop loss.

This can be confirmed by working out the underlying value of five contracts:

Buy 4 contracts x 3450 x 10€/point = 138,000€
Sell 4 contracts x 3440 x 10€/point = 137,600€
Therefore a loss of 400€

Trading Mistakes

Making profits in the markets is never "easy". The reality is that a trader who does everything right and stays focused may still record losing days or weeks.

Just imagine the results of a trader who does not do the right thing, makes silly mistakes and loses control of himself or herself and his or her emotions! Their results will be much worse.

Below are some of the most common mistakes we have witnessed over the years in this profession.

Missing a trade

A good set-up on a trading system can be overlooked if the trader is not focused. This might be a result of talking on the phone, surfing the net, or other distractions. It might be the result of focusing too closely on one time-frame to the exclusion of others. For instance, our system is used to trade on time-based bars, range-based bars, volume-based bars, and so on. Too much focus on only one of the time frames can cause trades to be missed in other time frames.

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Gut feeling
Many a perfect trade set-up has been ignored because the trader's "gut-feeling" told him or her; the set-up was wrong. Don't fall into this trap. A perfect set-up is just that, perfect – and the trade should be taken.

Conflicting buy and sell orders
In the case of conflicting buy and sell signals for the same trade, the common-sense response is to stand aside. Only the highest probability trade set-ups should be entered, and this is clearly not the case if there are conflicting signals.

Check the candlesticks
Be aware that occasionally the charting software may deliver a 'bad tick' and displays an incorrect candle. A filled in candle may actually have the close above the open, and vice-versa. It always pays to remain focused and to check the opening and closing prices if one has any suspicion the chart may be incorrect.

Second-bites
If a trade is missed, often the opportunity to take the trade will come along a little later, on a price retracement. In situations such as this, the trader should place a limit order where the original signal occurred and wait to be filled. Under some conditions it may be acceptable to 'chase' the trade by placing a market order, but in most circumstances achieving the best fill possible poses the least risk and is therefore the better option.

The Benefits of Working with a Coach

Learning how to successfully trade can take years of experience, of making mistakes and costly losses. Obviously everyone has different skills and abilities, and some people can understand the concepts and "tricks of the trade" at a quicker pace than others, but the unfortunate truth is that the cost and time involved, as well as the level of understanding, can exclude some people from the potential and opportunities presented by day trading.

Your Trading Room, however, has opened up the industry to everybody by putting together a successful team of trading coaches that provide in-depth traders' education and trade signal service in order to give their clients the best possible chance of succeeding and remaining profitable as a trader.

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The key difference, of providing a continuous trade signal service 24/5 in each market and of using high probability trade setups that are rule-based, removes all guesswork or 'second guessing' from the trade opportunity. Your Trading Room takes advantage of the money management and risk guidelines, as well as the trade signal service - something that is not offered by other services available today.

Your Trading Room coaches are experienced professional traders. They trade their own money in the live market and clients can take every trade they call. Experience has shown that the main reason traders fail, even under guided trading in trade rooms, is because they do not take the trade signals called or feel they need to outguess the trade coach.

To be successful in a particular industry or field, one must work with the best, and Your Trading Room has opened this opportunity up to anybody, regardless of skill level, location or profession.

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Chapter Eleven
Psychology and Risk

Your Trading Coach says:

“Forget the money, just focus on the trade. My trading strategies work, just do it!

Take the trade and eliminate all emotion. I take every signal according to my rules. I do not hesitate, I am fearless.”

Mathematical Probability and Expectancy

Most people who attempt to trade the markets lose money. This is just reality. The ratio of profitable traders versus unprofitable traders is often put somewhere in a range between 30/70 to 10/90. That is, 70 to 90 percent of traders lose money in the markets. These figures, thanks to research, are often referred to quite authoritatively. However, it is enough to know that more traders lose than win. This raises two questions: if 90% of traders are losers in the markets, does it mean that *you* have a 90% chance of losing in the markets? And what is it about the 10% who are winners that sets them apart? What do the winners do that the losers don't? What makes them the winners?

Understanding How Trading Profits Are Generated

Profitable trading can be summarised under six key concepts:

- The probability of a profitable trade;
- The average dollar amount of a profitable trade;
- The average dollar amount of a losing trade;
- The opportunity to trade - or the number of trades taken;
- The size of the trading account;
- The behaviour of the trader.

We will consider each in turn, with trader behaviour being covered in the section on trading psychology.

The Probability of a Profitable Trade

The probability of a profitable trade can be deduced by observing the results of your own trading system. Once the probability of a profitable trade has been found, the probability of an unprofitable trade can also be found easily using the following simple equation:

Probability of a profitable trade + Probability of an unprofitable trade = 100%

This is relatively straightforward. For instance, if your trading system has a probability of profit of 50%, then each trade one takes has a one in two chance of being a profitable trade. There is a lot more to probability than this simple conclusion, though, and we

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need to examine in greater detail the implications of probability to your success as a trader.
To help further our understanding of probability and its implications, let's, for the time being, depart the world of trading, and consider probability in the context of something readily understandable; tossing a coin. The toss of a coin can be likened to a "system" with a probability of success of 50%, or one in two. That is, the coin can either come up heads or tails, with each having a probability of 50%.

Toss a coin, let it fall to the ground, note the result (head or tail), pick it up. Answer this question – if the result was a head on that toss, what is the probability of a head appearing now, on the next toss? Of course, it is 50%. The previous toss will have no effect on the result of the toss to come. Each toss of a coin is said to be *independent.*

Let's imagine we have tossed a coin five times, and each time a head was the result. The result, then, looks like this: H H H H H.

What is the probability of a head on the next toss?

Pose this question to many people, and the answer received will be that the most likely result on the next toss is a tail. Of course, that answer is incorrect. The probability of the next toss being a head (or a tail) is still 50%. And yet, it is a misunderstanding of this point that leads to what is known as the ***Gambler's Fallacy***.

The Gambler's Fallacy

Definition

The Gambler's Fallacy is the belief that when there is a series of the same result observed in a random sequence, then a change in the series is due.

The "theory" behind the concept is a fallacy because each trial (toss of the coin, or trade, or roll of a roulette wheel) is *independent* of the previous trial. The Gambler's Fallacy, however, should not be dismissed lightly. It is a fallacy held by many, and is an important plank in the economy. Casinos employ many people and provide many owners, and governments, with excellent returns!

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Roulette players are one of the most obvious exponents of the Gambler's Fallacy in action. After a series of reds on a roulette wheel, many players put money on black (or vice versa). Yet, on any fair roulette wheel (if it is not 'fair' then we have a different issue completely) each roll of the ball is independent. A series of reds does not increase the probability of a black on the next roll.

Why people succumb to the Gambler's Fallacy is quite easily understandable; people get confused in their understanding of where they are in time.

It is quite unreasonable to be able to toss 10 heads in a row. Pull out a coin and give it a try. In fact, the probability of tossing 10 heads in a row is 0.00098, that's around one in 1,000; which translates as very unlikely. However, let's assume one has already tossed nine heads in a row. What's the probability of the next toss being a head? Now it is not 1 in 1,000, or anything like it. Given that each toss is independent, the probability of a head is one in two, or 50%. Try telling that to a gambler, though! Even those that understand probability and can locate themselves in time quite readily may find an emotional, or gut-level, feeling that surely the next toss must result in a tail! People's ability to move back and forward in time in their heads very, very easily, and their reliance on emotion and not reason when making decisions, can perhaps account for the prevalence of acceptance of the Gambler's Fallacy.

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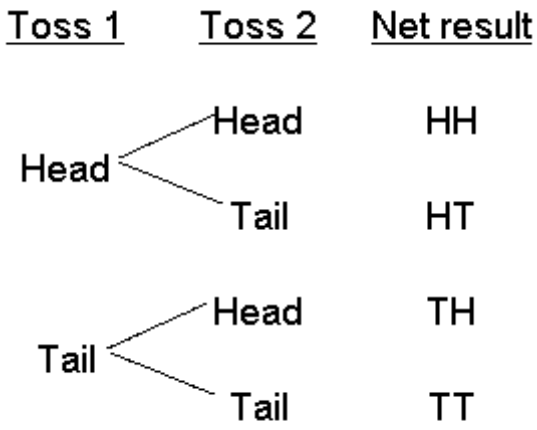
The probability of a series of consecutive profits or losses

We have already seen how we can assess the probability of a successful trade, but now we want to assess the probability of a *series* of consecutive profits or losses.

We will start with a consideration of the probability of two consecutive profits (or, indeed of two consecutive losses), assuming that the probability of profitability on any one trade is 50%. Continuing with the coin toss analogy, one method of calculating the probability of a series of wins or losses is to draw an outcome tree:



Given that the probability of a profitable trade under our assumption is 50%, simply replace Head with 'profit' and Tail with 'loss' (or, indeed, vice versa if one wishes).

The column labelled 'Net result' shows us the four possible outcomes of two coin tosses: a head followed by a head (profit followed by profit); a head followed by a tail (profit followed by loss); a tail followed by a head (loss followed by profit); or a tail followed by a tail (loss followed by loss). Now one can see the probability of two heads (or profits) in a row is one outcome in four possible outcomes, or 25%.

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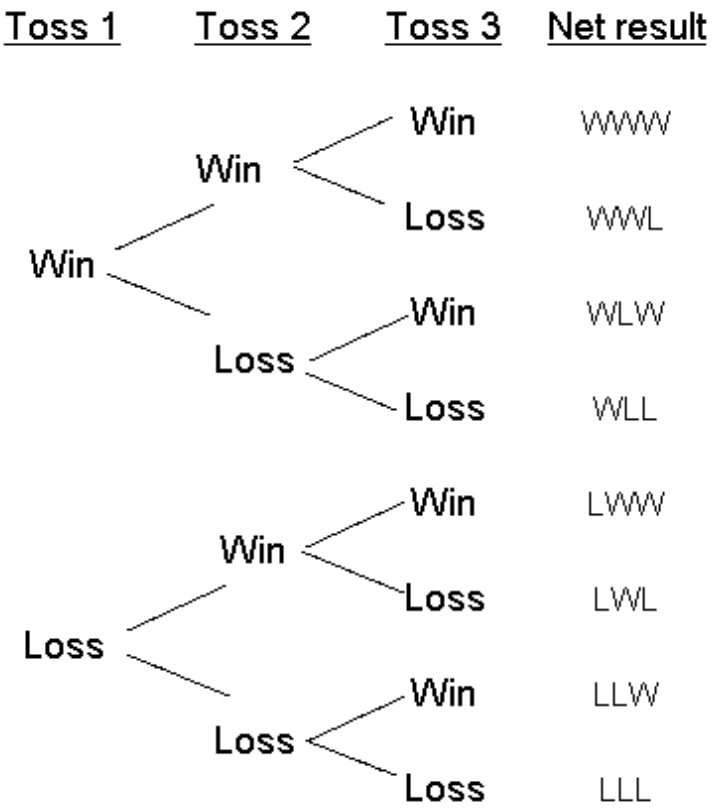
Outcome trees can be used to assess the probability of greater strings of profits or losses. What is the probability of three wins in a row?



So, the probability of three wins a row is one outcome in eight, or 12.5%.

There is a simpler way of working out the probability of a string of wins or losses, using this equation:

Probability of *x* losses in a row = (Probability of a loss) to the power of *x.*

In our example above, where the probability of a loss on any trade is 0.5, then for three losses in a row:

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Probability of 3 losses in a row = (0.5) to the power of 3 = (0.5 x 0.5 x 0.5)
= 0.125

It is when considering strings of profits and losses that the critical importance of probability to traders becomes apparent. What is the probability of three losses in a row? From above we can see that it is 12.5%. So, when one is about to embark on a series of trades (don't forget we are using our assumption of the probability of a profit on any *one* trade is 50%), the probability of suffering three losses in a row is 12.5%.

Similarly, the probability of:

4 losses in a row is 1 in 16 (or 6.25%);
5 losses in a row is 1 in 32 (3.1% with rounding);
6 losses in a row is 1 in 64 (or 1.6% with rounding).

(Obviously our figures here are based on a system with a 50% probability of a profit or loss *on any one trade*).

This consideration of consecutive losses is important to traders, as suffering through a string of losses not only causes the trading account to deplete, but can also create uncertainty and fear in a trader's mind; that his trading system is not working as it should. However, if a trader is following his system and he suffers three losses in a row, this may be perfectly normal, and in fact it should be expected to happen around 12.5% of the time. Similarly, four consecutive losses should be expected to occur 6.25% of the time. Five consecutive losses should be expected to occur 3.1% of the time.

Another, perhaps easier way, of understanding that a string of losses can be expected is to think of a group of, say, 1,000 traders, all using trading systems with a probability of profit or loss on any one trade of 50%, and all trading their plans according to the rules and procedures of their plans, i.e. all doing nothing wrong. Over the course of three trades, it should be expected that 125 of these traders (i.e. 12.5% of them) have suffered three losses in a row, doing nothing more than following their trading plan! Over the course of four trades, around 62 of the 1000 (i.e. around 6.125% of them) will have suffered four losses in a row, while over the course of five trades, around 32 of the 1000 (i.e. around 3.1%) will have suffered four losses in a row.

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This understanding brings us to a conclusion – **due to the nature of probability a trader can suffer a series of profits or losses while doing nothing wrong!** Such strings of profits or losses are events to be lived through; they are a part of life for traders.
This understanding also brings us to an important conclusion for our own trading. **Since strings of consecutive losses (and, of course profits) are going to occur from time to time, it is critical that we plan for these occurrences.** The way to plan for such occurrences is to control how much of our money we risk every time we take a trade. If we risk 50% of our initial trading capital on each trade we take, for instance, it will take a string of two consecutive losses to see us lose all our capital and be forced out of trading. If we risk 33% of our initial trading capital on each trade we take, it will take a string of three consecutive losses to see us lose all our capital. If we risk 25% of our initial trading capital on each trade we take, it will take a string of four consecutive losses to see us lose all our capital. This brings us to the realisation that we must manage our trading capital very carefully.

There is another trap that a trader can fall into. This is a dangerous trap and it is caused by a misunderstanding of the nature of probability and embracing of the Gambler's Fallacy. Its result is usually a total loss of capital.

Martingale Betting Strategy

Definition

The Martingale Betting Strategy refers to a situation where the gambler increases his bet size after a loss.

Let's return to the roulette wheel at the casino, a wheel that has just given six consecutive reds. Imagine a gambler now saying to himself, "After six consecutive reds, a black is sure to result next!" *(*The Gambler's Fallacy in action*).*

Our gambler has $3000 to play with tonight, but he wants to manage his capital so he only places $200 on black.

The ball is rolled…and comes up… red.

"Hmmmm," thinks our gambler. "That was bad luck, but now, with seven reds in a row, a black should be next. I will bet $400 on black this time, and when I win, I will recover the $200 I lost on the

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previous roll as well as a win on this one." (The Martingale Betting Strategy in action.)

The ball is rolled…and comes up… red.
Hmmmm", thinks our gambler. "That was bad luck, but now, with eight reds in a row, a black should be next. I will bet $800 on black this time, and when I win, I will recover the $600 I lost on the previous rolls as well as a win on this one."

The ball is rolled…and comes up…red.

Now our gambler has lost $1400. Need we go on? The next bet, using a Martingale Strategy is for $1600 (the balance of his remaining funds). The probability of the next roll being a black (or a red, of course), is just 50%. (Actually it is less than 50% as the roulette wheel has a green zero on it!)

We can apply the example we have just discussed to a trader. A trader who suffers a losing trade might choose to outlay more capital on his next trade, under the delusion of the Gambler's Fallacy and using a Martingale Strategy to "catch-up". That is, as the trader's account equity declines, his position size increase. There is a pithy saying in the market to describe this: "double-up to catch-up", and doing so is extremely dangerous. The results will be similar to our example gambler; greater losses compounding until an eventual loss of all capital when the "bad luck" series of trades that must eventually come good, doesn't – the capital runs out first.

The alternative to a Martingale Strategy is an ***Anti-martingale Strategy***, where one's risk increases as one has winning trades, i.e. position size increases as account equity increases.

One final point to mention (and it's an important point) is that when searching for a suitable trading system, many beginning traders (perhaps the majority) focus on the probability of a profitable trade as the sole arbiter of the value of the trading system. That is, the other five points we are about to cover are dismissed as unimportant, or of less relevance than the probability question. This is completely and utterly misguided – all six of these points we are examining are of critical importance. We now move on to points two and three of our determinants of trading success; the average size of our profitable trades and the average size of our losing trades. It is useful to consider these two points together, and discuss differences between them when necessary.

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The Average Profit and the Average Loss

The first point we considered in understanding profitable trading was the probability of a profitable trade. It is not unusual for traders to come up with trading systems, or plans, which show a very high probability of a profitable trade. "Buy and hold" investors, for instance, may be able to show that over the 10 years that they have held a basket of "blue chip" shares, that nine out 10 of them have gone up in price, which is a 90% success rate! This may be true, but it only considers one component of the six that make for a profitable trading plan. The average profit size, our next point, of such a buy and hold strategy may be very small. The point is that saying one has a system with a 90% success rate only answers one part of a six-part question. Similarly, the average loss size needs to be considered. It is to these next two parts of the question that we now turn; the average dollar amount of a profitable trade, and the average dollar amount of a losing trade.

We will first discuss the average dollar amount of a profitable trade, as many of the principles we discuss are also applicable to the average dollar amount of losing trades.

There are two determinants of how profitable any trade is going to be. Determinant number one is the nature of the system we are using to determine when to buy and when to sell. Determinant number two is whether or not we, as traders, actually follow our system!

It is useful to consider the differences between these two components. For the sake of simplicity, let's only consider entering long positions, although exactly the same principles apply when short selling.

When a trader is making a decision to buy into a position, one is in a completely different position from when one is deciding to sell that position. Prior to buying, a trader is waiting for the market to conform to a set of "entry criteria", i.e. a trader only buys once the price action gives an entry signal. If no signal is given, the trader is in the luxurious position of being free to stand aside and wait until

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another opportunity presents itself. This gives a trader a high degree of control over their entries.

This is quite different to the position a trader finds himself or herself in once they have initiated a position. Once entered, the trader does not have the luxury of watching any and all market developments and being very choosy about which ones they will react to. The risk attached to price movement now that they are in a trade *must* be actively managed. If the market does not do what the trader is expecting, he or she cannot ignore it and switch their attention elsewhere; they must make decisions to manage the risk.

Some traders, recognising the difference between the two sets of circumstance, assert that a trader has control in the first instance, and no control in the second. A little thought, however, will show that this is not the case. A trader never has control over price movement; they never have control over the markets. The market is going to do what it is going to do. Prior to entering, a trader has the power to choose whether or not to participate. This discretionary power should not be viewed, however, as having control over the market. Once in a trade, the trader loses this discretionary power as to whether or not to participate in the market, but his degree of control over the market is unchanged.

Having said this, traders do (or should) have control over one thing – themselves. This is not just semantics. It is of vital importance**,** especially when managing a position one already has. Let's say a trader has chosen to enter and is now managing his market exposure. We have already established that his degree of control over the market is zero. So an important part of the determinant of whether the trade will turn out to be profitable or not is thus beyond his control. As we have seen, the market is going to do what it is going to do.

Let's say, however, that the market moves in his favour and that price trades continues to trade higher (this applies equally if in a short position). The trade is now showing a potential profit, which could be converted to an actual profit if sold. How should a trader decide whether or not to convert this potential profit into actual profit? Of course, this decision should be made according to his trading plan, i.e. his trading plan should tell him when to sell. Whether or not a trader actually follows his or her trading plan is where a trader's control over himself or herself enters the equation.

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If their trading system is giving a sell signal, then traders should sell. But the actual decision and execution of the signal is entirely up to the traders. They may choose not to sell, because they are of the belief that price is going to continue higher. What they are basing this belief on is not of much relevance; the point is that the traders should be following their plan, and exiting the position.

Another alternative is that the trader's trading plan is not giving a sell signal, but the trader may decide to sell anyway. The thought of converting a potential profit into an actual profit may prove too much for the trader's self control to handle. Again, the point is that the trader, if selling without a sell signal, is not following his or her plan.

Let's change the circumstances somewhat now and imagine that, having entered a long position, the trader is faced with price moving against them; i.e. the price is falling. This is not an unusual circumstance; all traders have trades that go against them, and many, many profitable traders actually have more trades go against them than go in their favour. How is this possible?

Successful traders recognise the inevitability of having losing trades, but their success stems from an acceptance of this fact and the ability to manage the losses. Managing one's loss means to **keep the average loss size small**. Average loss size is kept small by using a tool called a **stop loss**. A stop loss is a price that is nominated by the trader as being the point at which the position will be exited, if the price falls.

A **stop loss order** is an instruction given to a broker to exit a position if the price moves against the initiating position by a *fixed and predetermined amount*. Most successful traders use a stop loss. Of course, the traders themselves can execute stop losses by either using a broker or directly through their online trading platform.

Stop losses should **never** be lowered from their initial point; a trailing stop loss can only move such as to **reduce** the risk on a trade, not increase it. As the share price moves up, a trailing stop loss may, in time, be placed at a level above the entry price. When the stop loss is above the entry price the stop loss is said to be a **stop profit**.

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The same issues that were raised about a trader's reaction when faced with a signal to exit for a profit apply when a trader is faced with a signal to exit at a loss. While the trading system may be flashing a sell signal, the actual decision and execution of the signal is entirely up to the trader. He or she may choose not to sell, because of the belief that price is going to return to higher levels. What they are basing this belief on is not of much relevance, the point is that the trader should be following his or her plan and exiting the position.

Another alternative is that the trader's trading plan is not giving a stop loss signal, but the trader may decide to exit anyway. The thought of suffering further losses if the price continues to retreat to the stop loss level may prove too much for the trader's self control to handle. Again, the point is that the trader, if he or she exits without an exit signal, is not following the plan.

These important points about traders' control over their actions need to be considered in more detail. This will be done in a following section of this part of the notes; section 6: *The behaviour of the trader*. For now, though, we want to combine the first three points we have considered: the probability of a profitable trade; the average dollar size of profits; and the average dollar size of losses. Combining these three points gives us what is referred to as ***the Expectancy equation***.

EP = (PPT x AP) – (PPL x AL)
where
EP = Expected Profit
PPT = Probability of a profitable trade
PLT = Probability of a losing trade
AP = Average profit ($)
AL = Average loss ($)

This is fairly straightforward; what the expectancy equation is telling us is the profit we can expect to make on any one trade. Obviously, for success, a trader's expectancy must be positive. Note the expectancy equation does not give us the actual profit (or loss) that is expected to be realised on any one trade. Summing up the expectancies across a number of trades also does not give us actual figures over a number of trades. The expectancy equation uses averages to give us some sort of *expectation* of profits over a series of trades. The longer the series of trades, the more the

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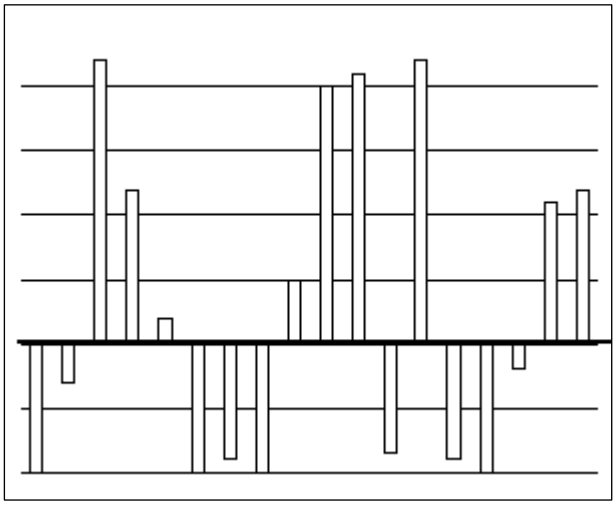
actual profit results should approximate the expectancy equation results.

This, again, is not just semantics; knowledge of what the expectancy equation is actually showing us is also knowledge of the correct way to go about trading. To trade is a verb – it is something we *do*.

Trading is not about what results we will get on any one trade. Any one trade may be a profit or a loss; its outcome is uncertain at the time of entry into the position. We are not, however, concerned with individual trades. The expectancy equation points the way to understanding trading – we are interested in our results across a series of trades. Trading is an ongoing process and needs to be viewed as an enterprise that takes place across a number of trades. We have seen from our discussion of probability that a trade might be profitable and it may not be; a series of two trades may both be profitable, both be not profitable, or one of each; a series of three trades may have eight different outcomes; and so on.

An effective way of visualising the impact of managing trades correctly is by using your profit exits and your stop loss exits, and combining them into the expectancy equation using a diagram such as the one below; where losses are represented by bars below the horizontal line, and profits by bars above the horizontal line. Note the bars below the line are all kept to a maximum around the same level by the use of stop losses; those not reaching this maximum are where trailing stop losses have reduced the losses on trades.



This is, of course, a hypothetical example, but it serves to illustrate the impact of the use of stop loss orders – losses are kept to some maximum (of course it's possible slippage may increase some losses beyond this desired maximum).

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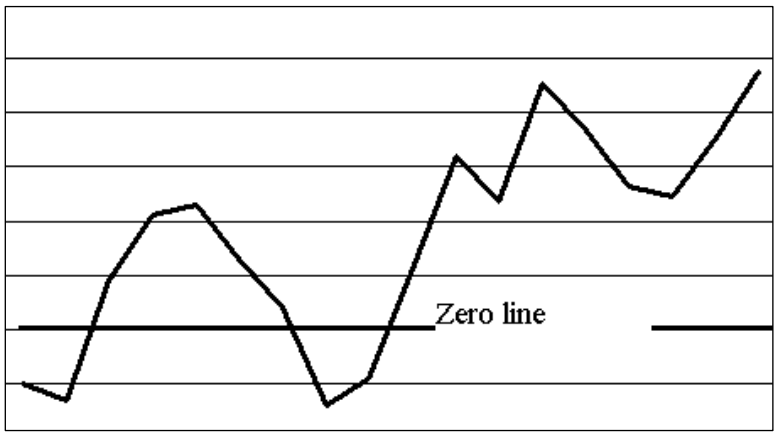
Such results translate to an equity curve, above which shows increases and decreases in equity. This equity curve is a result of 18 hypothetical trades we have used in the example above. Over time an equity curve should display a smooth upward slope, with minimum drawdown. A drawdown is the difference between the peaks and troughs of an equity curve.

The Opportunity to Trade

The expectancy equation gives us our expectation of the profit we will realise on any one trade. Let's hold all three variables in the expectancy equation constant now; and let's ask what sort of profits we can expect *over time*. This will obviously depend on the number of trades that are taken. A positive expectancy, multiplied by the number of trades taken, should give us an approximation of profitability over time.

An important point to note here is that the number of trades taken over time is dependent on the number of entry signals given by the trading plan, and executed by the trader. Thus, the number of trades taken will be dependent on how the market behaves, i.e. is the market behaving in such a way that an entry signal is being given? Again, the illusion that the trader has any control over how the market is behaving needs to be dismissed. The



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trader only has control over how he or she behaves, not over how the market behaves.

The Size of the Trading Account

In online futures trading (as opposed to share trading via traditional brokers, which attracts larger fees and commissions), the size of the trading account impacts upon the results we achieve in trading in only one way – the larger the account, the greater the return *in dollar terms*. Percentage-wise, the return will be exactly the same, regardless of account size.

For example, assuming a per-contract margin requirement of $1,000, a trade that profits by 10%, for instance, will return $100 on a one contract position, $1,000 on a 10 contract position, or $10,000 on a 100 contract position.

Large 'block' traders may be able to negotiate smaller commissions, but with 'round-trip' brokerage, including exchange fees and data feed, currently at around US$5.00, the actual savings in percentage terms are minimal. Large positions may also present liquidity problems and so the advantage to such traders is somewhat minimised.

Introduction to Reflexivity and Trading Psychology

There are many aspects to the psychology of trading and it is impossible to cover them all here. However, a few examples will suffice to show that all trading psychological concepts lead to the same conclusion. Namely, traders cannot trust instinctive or spur-of-the-moment thinking when it comes to markets. This is hard for anyone to learn simply because of the fact that, in life in general, our instincts frequently serve us well. An instinctive fear of spiders and snakes has obvious adaptive advantages. Many will agree that our first impressions when meeting someone new often turn out to be spot-on. Logical analysis rarely improves on this instinct or 'feeling'. Markets work precisely in the reverse; instincts and feelings lead us to the wrong conclusion.

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The Perceptions of Others

There is a natural psychological tendency for human beings to use the perceptions of others as if they are objective fact. If many people believe or perceive something to be true, the more believable it becomes for us. The reason for this phenomenon is quite clear; society would develop very slowly if people had to prove everything for themselves individually. We shorten the process of developing knowledge by taking for granted the work and beliefs of others. Of course, one instance (or person) does not prove anything. However, since practically every physicist accepts Einstein's theory of relativity for example, we comfortably accept this theory as well. We are quite confident that there is no need for every person to try and reproduce his experiments. The end result of this psychological process is that the more people who hold and espouse a belief, the more believable it becomes.

History is littered with examples showing the general acceptance of erroneous beliefs. Take the flat earth theory for example. Once upon a time the earth was considered flat by everyone. The belief was so strongly held that if anyone dared to contradict it, they risked being outcast as a heretic, and in many cases suffered dire punishment including imprisonment and even death! Of course we now know the truth – but in times past, no one really had the faintest idea what shape the earth was.

In following the financial markets, we naturally follow the same process. The more people say something, or believe in a theory or thought pattern, the more believable it becomes and then the more likely others are to believe in it. The pool of people acting on the thought thus increases. As people convert their beliefs and thoughts into action, those actions then drive prices. The resulting price movement then 'proves' the thought; so more people accept the thought and then act accordingly. The result is a feedback mechanism between the market and 'thinking participants'. The feedback mechanism tends to drive prices along with participants' thoughts *even though there may be no basis in objective reality.*

George Soros, the legendary fund manager, first discussed this philosophical view of markets. He coined the term ***reflexivity*** since the concept is related to the reflexive verb, which has the subject as its object. The markets, and the participants' thoughts, are in effect the same thing. What really is an asset's worth after all?

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It is simply worth what someone is prepared to pay for it. In other words, it is worth what people think it is worth.

> *" …… in the case of thinking participants(.) there is a two way connection. On the one hand, participants seek to understand the situation in which they participate. They seek to form a picture that corresponds to reality. I call this the passive or cognitive function. On the other hand, they seek to make an impact, to mould reality to their desires. I call this the active or participating function. When both functions are at work at the same time, I call the situation reflexive."*
> *(Ref: The Crisis of Global Capitalism by George Soros 1998)*

As a result, markets are driven by the models or pictures of the situation that participants form in their minds. Participants' actions based on these models create a situation where the models tend to take on a life of their own, whether there is any basis in reality or not.

Scientists go through a similar process. To prove a theory, a model of nature is initially proposed, and then an experiment is conducted to test objective reality. If the result of the experiment matches what the model predicts, then the experiment has provided evidence to confirm the theory. The process continues until much evidence is collected, and if no experiment fails to confirm the model, then the model is accepted as fact.

This process has worked effectively until relatively recent times. Modern physics however, has begun to investigate the very large and the very small; the universe on one hand and sub-atomic particles on the other. A few examples include Einstein's Theory of Relativity, Heisenberg's Uncertainty Principal, Schroedinger's wave equations, and quantum mechanics, all have altered our view of the world. Objective reality has turned out to be not quite as objective as once thought. It is now well known among physicists that *the observer influences the observed*. The type of experimental design actually affects the results, so there appears to be no reality outside of our measurements.

When it comes to the markets, traders have known for a long time that there really is no objective reality to measure 'value' against. This is why a market exists. Different people have different ways of determining value. The relative value of owning a stock or having the cash varies with people and their circumstances. The market is

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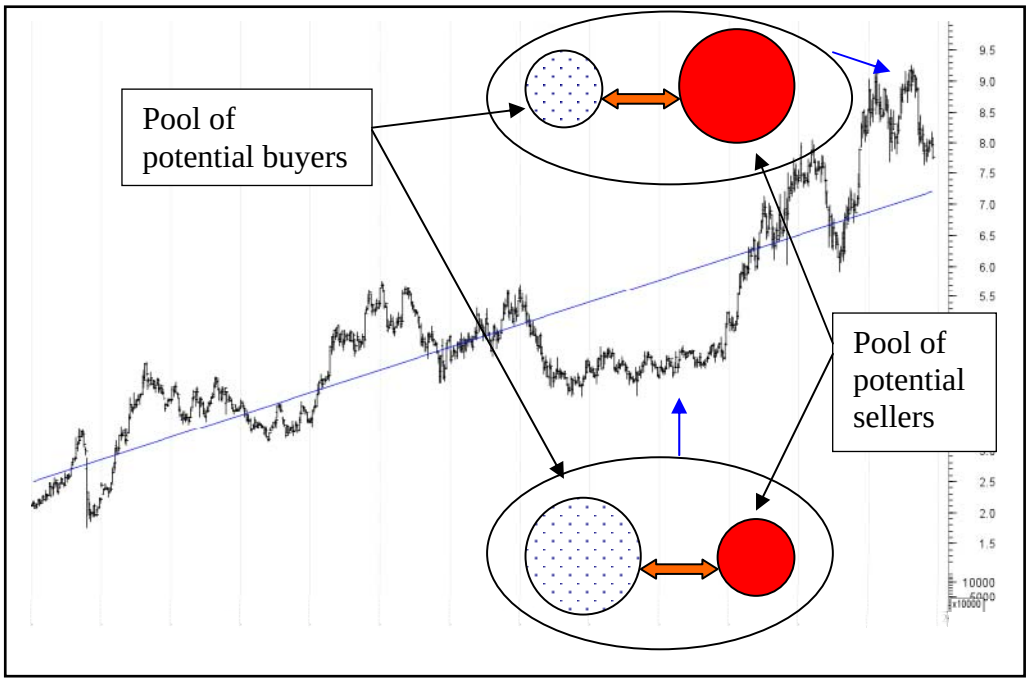
a crowd; the crowd will answer the same question differently at different times. There is no 'nature' for us to test and to provide definitive answers. This is what is meant by the term 'thinking participants'. In nature, the scientist thinks and nature participates in the experiment. In markets, the participants and the thinking are one and the same!

The Theory in Practice

If the theories discussed so far have left you a little perplexed, there is no need to worry. It is the practical applications that are important. When the link between theory and practice is made, the results become almost self-evident.

Firstly, consider what would happen if there really was a totally objective and unarguable reality to market prices. If this were so, then the market would always stay in balance around this price. Since everyone knows exactly what a security is really worth, no one would buy or sell at any other price. Markets would trade in a straight line with the occasional hiccup caused by new information releases that effected this calculation of value. In the case of the share price for a company, we could expect the rate of growth to be a straight line with a slope that is a function of the earnings of the company less dividends and less inflation with a factor for interest rates and future prospects. In a purely logical valuation, these are the only factors to be considered. Straight-line price graphs are not what we observe in real markets, however.



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The chart above shows a price chart with a linear regression line study. The linear regression is simply a mathematical formula that reduces a set of data to the straight line of 'best fit'. Observe how prices tend to swing in a wave pattern around the line. This is typical market behaviour. These swings are caused by the psychology of traders and the reflexivity theory discussed above.

To make the concept more concrete, consider what happens to market participants as they act upon thoughts about the market. When prices are low (though remember that no one can be too sure that they are low at the time) the pool of potential buyers is larger than the pool of potential sellers. Anyone who did not sell is presumably a long-term holder and is not considering selling anyway.

'Reasons' for a rising or falling future price, i.e. thoughts about the prospects of the asset, will circulate around the market. As prices pick up, the positive thoughts or reasons are 'confirmed'. The only reason for price rises is simply that the pool of potential buyers is larger than the pool of potential sellers. But anyway, the recently confirmed positive reasons become spoken about more frequently because the price 'confirms' these reasons more often (since price has moved into an up trend, which by definition rises more than it falls). Recall that the more something is spoken about, and the more people believe it, then the more believable it becomes. This is basic human psychology. There is nothing like rising prices to confirm one's positive thoughts and increase confidence in one's beliefs. As more people buy, the price rises, proving these people right *whatever their thoughts or reasons are*. Consequently, we speak these reasons more often and with more conviction. They are then picked up and accepted by others.

Near the top of the wave there are a lot of positive beliefs about the asset going around and there are a lot of people espousing those beliefs. This happens simply because the belief has been 'proven' by past rising prices. This is why confidence is high at market peaks; there are a lot of happy people who have paper profits in their account and strong beliefs in the thoughts that led to this position. Of course, there will still be some negative beliefs floating around. However those holding to these will tend to be less boisterous because the price has been proving them wrong.

Higher prices simply mean that the pool of potential buyers is shrinking, and *that the pool of future sellers is growing*.

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Interestingly, this happens when people are most confident. But all that is required is some selling to create a fall in price. The reverse of the process discussed so far creates a spiral or feedback loop. Negative thoughts are 'proven' so more people start to accept these thoughts or 'reasons' and then are moved to sell. Naturally this leads to further falling prices, which feeds back into traders' thought systems to create a negative view and to 'confirm' negative thoughts. As prices fall, and people accept negative thoughts because of their prevalence, the pool of potential future sellers shrinks as traders sell out. Lower prices later attract buyers and the pool of potential future buyers grows. And from here the cycle continues. It logically follows that low prices are thus formed when the accepted thought systems are most *negative*. This fits perfectly with what can be observed in real life; markets peak during booms and periods of confidence and trough during recessions and periods of low confidence (or high confidence in negative thoughts).

Remember that all along there is no objective reality to price anyway, so no real objective reasons actually exist! It is simply crowd psychology and the reflexivity of markets that drives the process. For the theory to work there was never any requirement for the thoughts to actually approximate any measure of reality! After gaining experience, it will seem to you, as it does to many others, that reasons for market movements tend to be 'tacked on' after the fact. During the process, both positive and negative thoughts are bandied around the market. Once the price moves some of these reasons 'stick' and others don't. Yet, there is no objectivity to it at all, nor can there be. Prevailing thought systems might hold absolutely no logic or any approximation to reality at all, as the future will undoubtedly show. It is just the same as how the present shows up the flat earth theories of the past.

The discussion above relates mostly to 'crowd' psychology. However, there are many other psychological factors that affect individual traders, and in turn individual traders' performance. Next we will cover some factors to keep in mind.

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The Need to Be Right

The need to be right about things is a natural human trait. Like most natural human traits, it makes a lot of sense in our day-to-day lives. In undertaking almost any type of human activity, it usually pays to do it correctly. The issue when considering trading behaviour in the financial markets is defining just what is 'correct'.

As we have already discussed, many beginning traders focus almost exclusively on the probability of a profitable trade when seeking a trading system. That is, many beginning traders are expressing a strong desire to have their trades turn out 'right', or profitable. But being 'right' on an individual trade is only one part of any trading system. A focus on being 'right', i.e. having a high probability system, to the exclusion of the other factors will frequently lead a trader astray.

Further, we need to define what being 'right' is in the share market. The correct definition of being right is to have a well-designed system, i.e. one with positive expectancy that a trader then *trades correctly*. The definition of being right in the share market, then, is *doing the right thing*. The definition of being right in the share market is NOT measured by the profitability of individual trades.

And yet, this desire to be 'right', i.e. profitable, on each trade one takes is normal and natural. People want to be right! Aspiring traders need to work on this desire to be right – to redefine 'being right' from the need to make a profitable trade, to the practice of actually following their trading plan.

The implication of this new definition is a little unnatural. What it means is that it's possible to do the right thing in the market, i.e. follow your trading rules to the letter, and yet have an unprofitable trade. Let's rephrase that more strongly – a trader may lose money on a trade but still be right! (Remember, the result on an individual trade is not important – it is the result over a series of trades that is important). Conversely – a trader can make money on a trade and be wrong! Many traders start out doing the wrong thing, and just happen to make some money doing so on a couple of trades. The way humans learn is through reinforcement – if doing the wrong thing is reinforced by making money, then doing the wrong thing is learnt as the way to trade. And over a series of trades net losses can be expected to result.

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In summary:

1. If one focuses on being right (i.e. making money) on individual trades, one is ignoring all the other factors that go into a profitable system. The focus should be on making money over a series of trades (i.e. positive expectancy).
2. The definition of being "right" needs to be "doing the right thing', i.e. following one's trading plan correctly.

The Endowment Effect

The Endowment Effect is particularly relevant to traders. The Endowment Effect states that the value of a product increases when it becomes part of a person's endowment (i.e. the person owns it). The result is that the person demands more to give up an object than they would be willing to pay to acquire it. An experiment conducted to show this effect involved giving a coffee mug to half of the students in a university economics class. The students who now owned the mugs were asked at what price they would be willing to sell their mugs (the average came to $5.25), while the students who did not own mugs were asked at what price they would be willing to buy (the average came to $2.50). That is, those who owned the coffee mugs valued them higher than those who did not own them.

The implications for traders are clear – once a trader enters a position (long or short) they may value it more highly than a non-participant – or more highly than it is currently trading at in the market. A trader valuing a position higher than it's currently trading in the market can have a problem when the time comes to exit the position, particularly if it's to execute a stop loss. The trader may find himself or herself unwilling to exit because he or she thinks they should have greater compensation and may thus decide to stay in the position, awaiting it going back to "true" value. This may cause a losing trade to be extended or a winning trade to actually lose value, often to the point of it becoming a loss.

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Loss Aversion

A fundamental part of human psychology is ***asymmetric loss aversion***; i.e. the pain of a loss is far greater than enjoyment of a gain. For example, if you find $20 in the street you may feel a certain amount of pleasure – let's call it 20 "units". However, if you *lose* $20 you will probably feel a much greater pain, say 40 "units". In financial markets the expression of this loss aversion is that a trader will feel twice as bad about losing money as feeling good about making a profit! The implication is that in order to avoid feeling bad, a trader may hold on to losing trades (i.e. not exit at their stop loss level).

The Disposition Effect

Consider two traders. Trader A bought five mini Dow contracts at 12,500. Trader B also bought five mini Dow contracts, but was a little late in entering, and the price quickly rose to 12,520, 20 points higher, or $500 more (5 lots x 20pts x $5 per pt). After a while the price drops to 12,510. Which of the two traders would be more upset?

Most respondents will nominate trader B as being more upset than A. After all, A has suffered a reduction in gain (but is still in profit), while B has suffered a loss. But, in fact, both of these two traders have lost the same amount of money since the high at 12,520.

Nevertheless, in most cases B will be more upset than A – such is the nature of human psychology. As previously noted, given that people are averse to loss, A is more likely to exit than is B. This is known as the *disposition effect* – people are more likely to exit profitable positions and hold on to unprofitable positions. A study of 10,000 share trading accounts conducted over seven years and covering 97,400 trades (Terrance Odean, 1996, 'Are Investors Reluctant to Realize their Losses?', Haas School of Business Research Program in Finance Working Paper Series, No. 269, November 1996) confirmed people's propensity to sell winning trades, and hang on to losers.

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The Fear of Regret

Another reason people tend to hang on to losing trades, to be added to the already long list of reasons, is the fear that once they exit, the price will turn around and go back in their favour, leading them to regret exiting. Some people avoid exiting profitable positions for the same reason – fear that the price will continue in their favour and they will regret exiting prematurely. We cannot know the future; this is the first thing we must accept. The next is that we exit our position because our trading system gives us an exit signal. However, no trading system is going to give us the correct signal all the time and so sometimes price will continue to travel in the favoured direction after the trader has exited their position. Such is the nature of the markets.

Found Money

People tend to put money into different mental "accounts". One nice demonstration of this is people who carry debt on their credit cards (at high rates of interest) or personal loans (again at high rates of interest) and yet place "savings" aside in a cash account each week or month. In such a situation it would make rational sense to pay off the high interest credit card or personal loan rather than place money at a lower interest rate (and pay tax on the earnings!).

Similarly, people place other money in separate mental accounts. Think of the situation where one has opened up a wallet or purse to pay for some goods only to discover that the $50 note that was in there is missing. Very frustrating; but after a quick visit to the ATM one pays for the goods and gets on with the day. Later that evening the $50 note is found in a jacket pocket, where it was placed

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absent-mindedly earlier on. The person now goes out for a quick dinner with the $50 he had misplaced earlier and has now "found". Of course, not everyone would do so, but many people would now consider this $50 as extra, to be spent as wished. It was given up as lost, but is now found and can be spent frivolously.

For traders, this "found" money can often be in the form of a quick, or greater than expected, profit on a trade. Many a trader has placed a trade in the morning and, upon returning from lunch, found themselves with a substantial profit already. The danger is that the trader then considers this "found" money can be placed in a riskier than normal trade, and if it is lost, no matter. This is a source of quite a few losses for traders and is an attitude that needs to be recognised and resisted; any profit, no matter how quickly derived, is just a profit-just a part of trading.

Summary

There is more that could be said on the impact of trader behaviour (or psychology). But in order to move on we can draw some conclusions here.

Each trader needs to do everything he or she can to recognise the potential dangers that normal human emotions pose to profitable decision making. It is quite normal for all the above descriptions of the emotional side of trading to get in the way of this decision-making process. It is also quite normal to be able to recognise these emotions and the dangers they pose, and yet still find it difficult to eliminate them. Again, this is quite normal. Humans do not just make decisions only with the head; the heart (or gut) also plays an important, and often ruling, role.

How, then, do we deal with this? There are a few guidelines.

- Before starting to trade, traders need to know what it is they want to achieve from trading. This sounds very basic, but how many of us know what we want? We are not talking of vague ideas here, but of defining as precisely as possible what our goals are. Solid academic research has shown the value of goal setting to a person's level of achievement. Ask yourself where you want to be in twenty, ten, five, one year, next week, tomorrow, etc, and what you need to do to get there.

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- As we have established, it is not enough to make decisions with just your head; your emotional needs should also be considered. Setting goals is a powerful way to get your emotions on side.
- Be as realistic and as detached as possible. It is important to try to view the trading process dispassionately. Do not focus on individual trades and the profits and losses of these individual trades; focus instead on the results over time.
- Control the risk on trades. Avoid taking risks that raise the emotional commitment to trades, such as trading with borrowed money.
- Work to remove the emotions from trading as completely as possible. Some professional traders have got their trading to such a level where they do not look at charts; their trading system generates buy and sell signals which are automatically faxed to brokers without the trader intervening at all! Such an approach to trading is a *mechanical* approach. The negation of the role of emotions that a mechanical approach allows is a great strength, and it is to mechanical trading that we maintain our focus.

According to a report by TheDisciplinedTrader.com, when traders get “in the groove” of trading, they are able to remove all emotion from trading, and ensure the process is strictly mechanical. Combining education, experiential and psychological conditioning is the most comprehensive way to reach a goal.

Remember, you cannot trust your thinking, beliefs or instincts once you are part of the market system and you cannot trust anyone else’s thinking.

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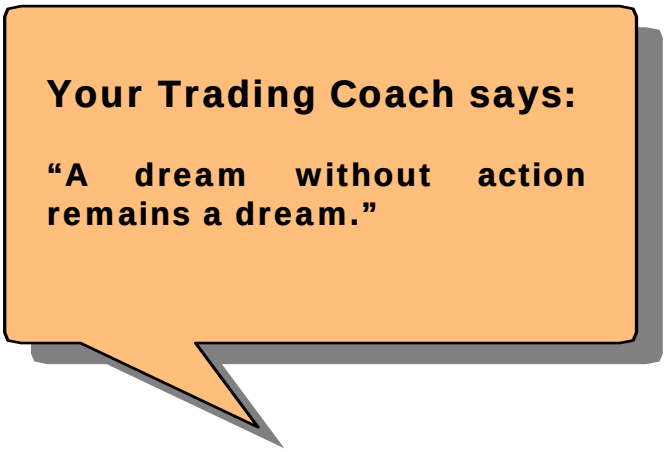
Chapter Twelve
YTR Strategies in Action



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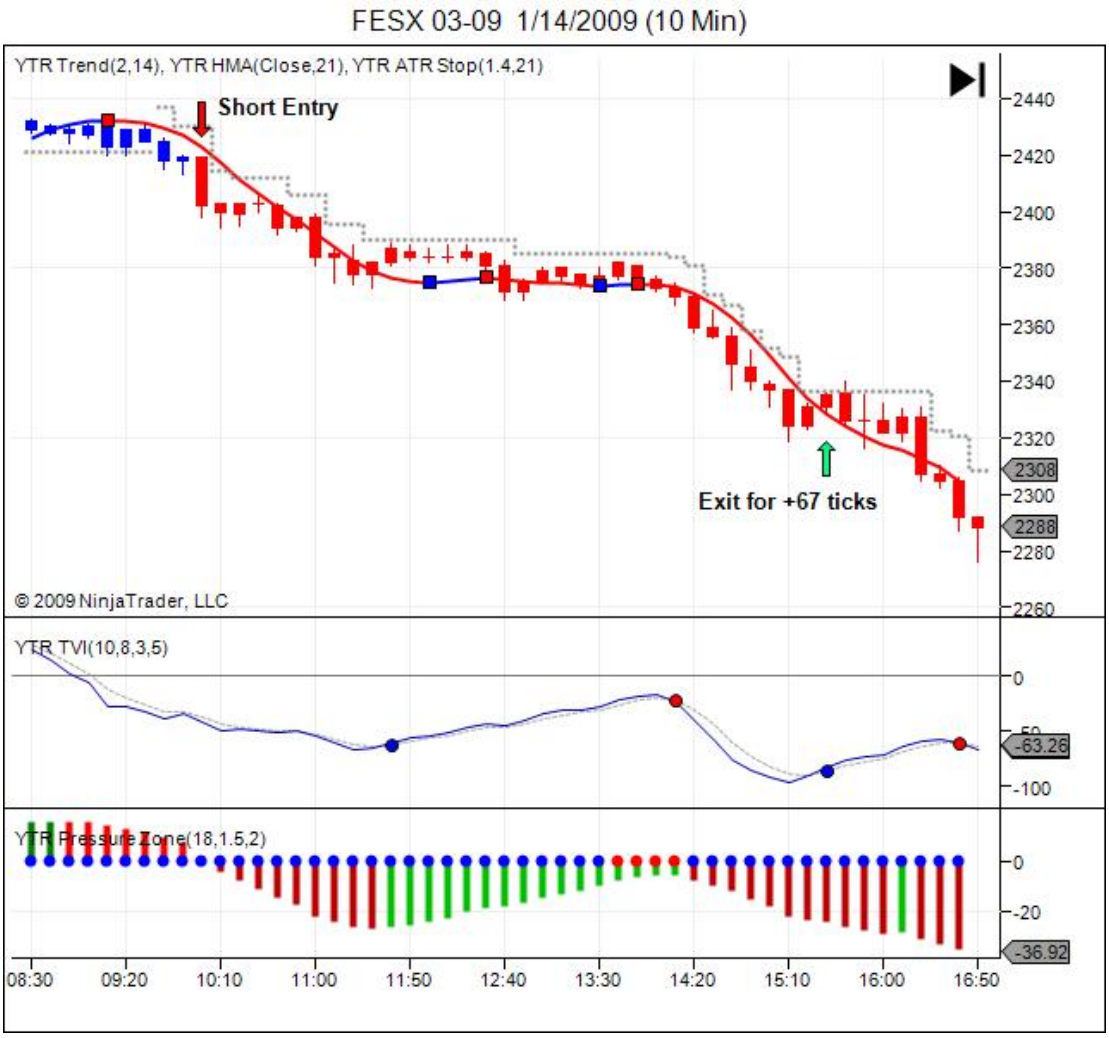
Strategy #2: The YTR Classic Trend.



Sixty-seven points on a 10 minute chart using the YTR ATR Stop for exiting.

The YTR Classic Trend strategy utilizes the same indicators as the YTR Scalper, but looks to gain longer term moves within the session.

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Strategy #3: The YTR NightRider.

Normally used to take 5–10 tick scalps, this great example of a NightRider buy signal delivered 27 points using a YTR ATR Stop to exit.

The YTR NightRider strategy uses the YTR Keltner Channel and YTR CCI to deliver consistent profits in all markets and timeframes.

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Strategy #4: The YTR TrendSetter Special (TSS).

Three signals to short and a minimum of 15 points profit in less than an hour using the TSS on a 3 minute DJ EuroSTOXX 50 chart.

The YTR TSS strategy includes all of the great features of the original YTR TrendSetter, yet takes traders to new levels of profitability. This system employs three moving averages and a cunning, but easily identifiable candlestick strategy to ensure consistent signal success.

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Strategy #5: The YTR Three-Line Break (3LB).

Three consecutive three-line break trades in just over an hour for a total of at least 31 points profit.

Steve Nison introduced Japanese Candlesticks to Western Hemisphere traders in the early 1990's, and with them, the Three-Line Break strategy. YTR have upgraded the methodology using a specially developed colour-coded indicator to consistently signal short and long term trend reversals.

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Strategy #6: The YTR Pivot Bounce.

Four consecutive winning pivot bounces using the Previous Day's Low and the Daily S1 support level. Total score in just 30 minutes? 24 points!

Pivots are turning points in the market, based on support and resistance levels. YTR has developed a Pivot Bounce strategy that takes advantage of these levels to deliver quick and easy returns to our members.

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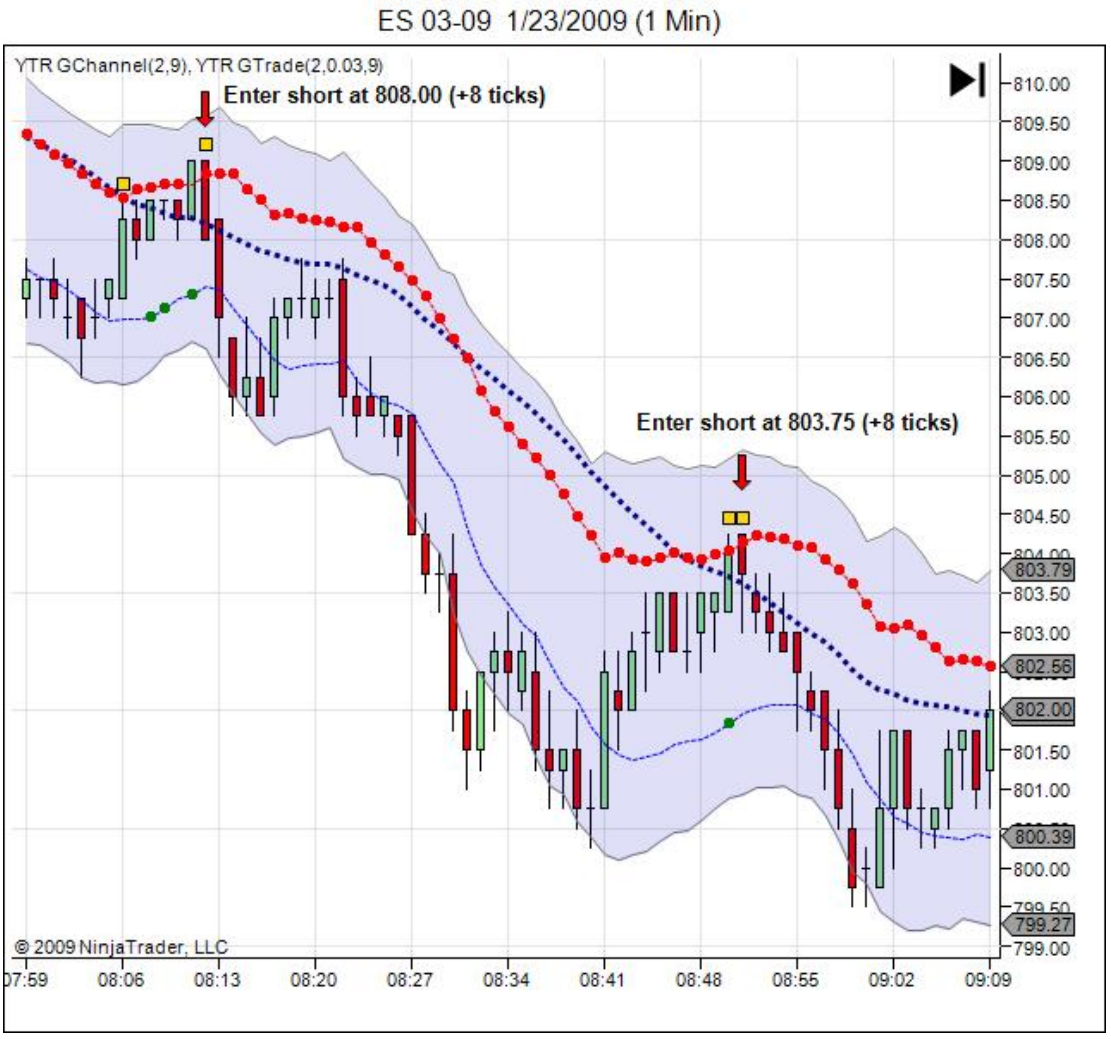
Strategy #7: The YTR GTrade.



Two short trades before the cash market opens on the ES picks up a minimum of 4 points, and potentially a lot more using the YTR GTrade strategy.

Opportunities abound using the YTR GTrade strategy, particularly in lower volume market conditions, such as the eMini S&P 500 contract during the premarket or overnight session. Clearly indentified entry signals guide the astute trader to sizeable earnings before the institutions have even opened for business. The early bird catches the worm!

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Conclusion

Your Trading Coach says:

“The greatest danger for most of us is not that our aim too high and we miss it, but that it is too low and we reach it.”

Michelangelo

What makes Your Trading Room Unique?

A day trader's life really is a smorgasbord of opportunities. Full time traders can choose their markets and their times. Part-time traders can choose their markets to fit in with their existing careers, while full-time traders fit their trading around friends, family and hobbies.

By joining yourtradingroom.com you'll be moving beyond any prior expectations you have. You'll share consistently reliable, high profit, low risk trading calls in real time. You'll know your entry and exit points, profit objectives and stop losses before you pull the trigger. And you'll be able to watch your coach use his or her own money to make the same trade.

Our strategies are tested and proven. Our proprietary indicators deliver consistent results. Yourtradingroom.com is unique in that you can sit side-by-side some of the best traders in the world and watch operating live in our state-of-the-art online trading rooms.

Your Trading Room's Nine Steps to Success

To be successful at any venture, please realise that you need to apply three non-negotiable facts:

1. Be willing to undertake training
2. Be willing to accept support
3. Be willing to follow a proven system

In *The Truth about Day Trading,* we have shared with you the concept of day trading as a hobby, a means of extra income, or indeed, as a profession. We have explored what components make up the day trading market, looked at the tools day traders work with, such as charts and candlesticks, and the psychological mindsets that can either make or break a trader.

On the following pages are our nine steps to your success as a day trader under our system. We hope you find them stimulating.

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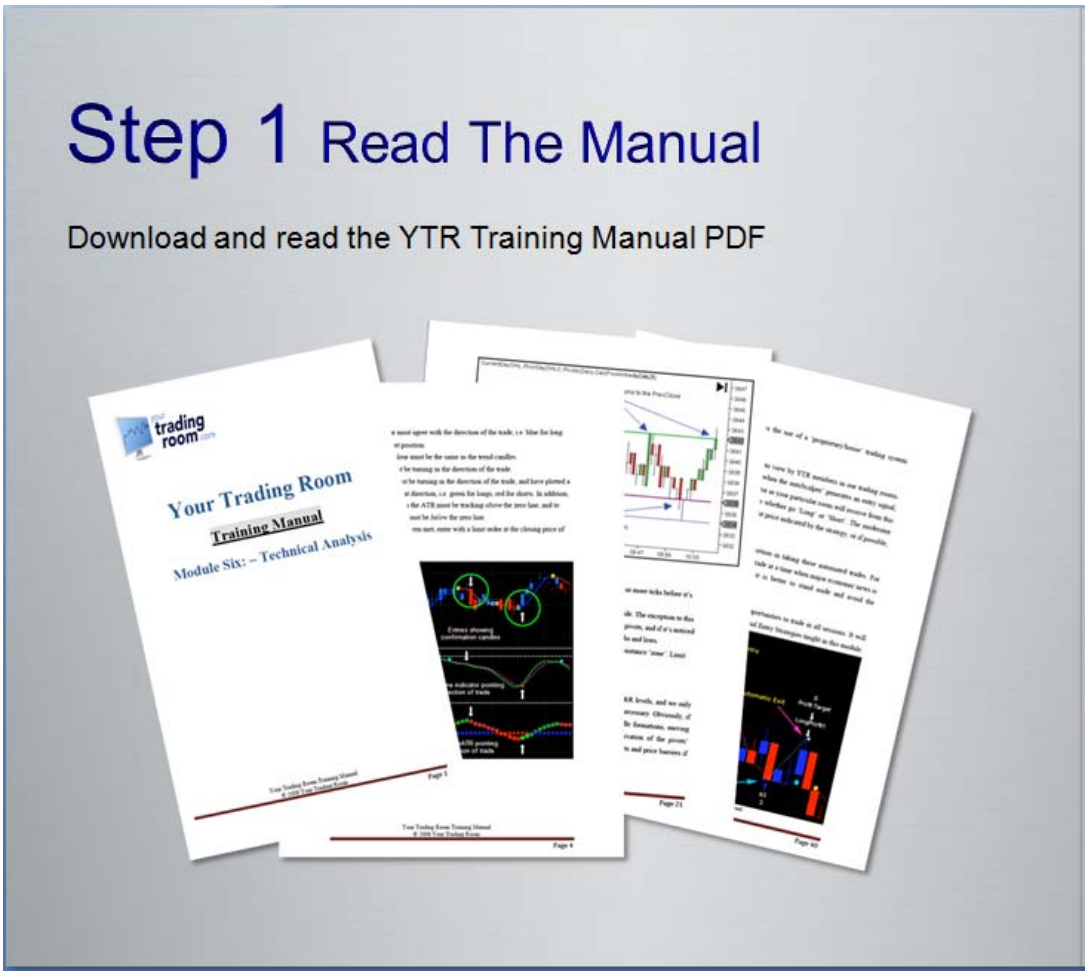
Step 1 Read The Manual
Download and read the YTR Training Manual PDF
Your Trading Room
Training Manual
Module Six: – Technical Analysis

Download and read the Your Trading Room manual from start to finish. Ask us if there is anything you are not clear about.

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Trade management, analytics & fast order execution
Develop & backtest automated trading strategies
FREE for advanced charting, system development, and trade simulation
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Undertake the NinjaTrader training.

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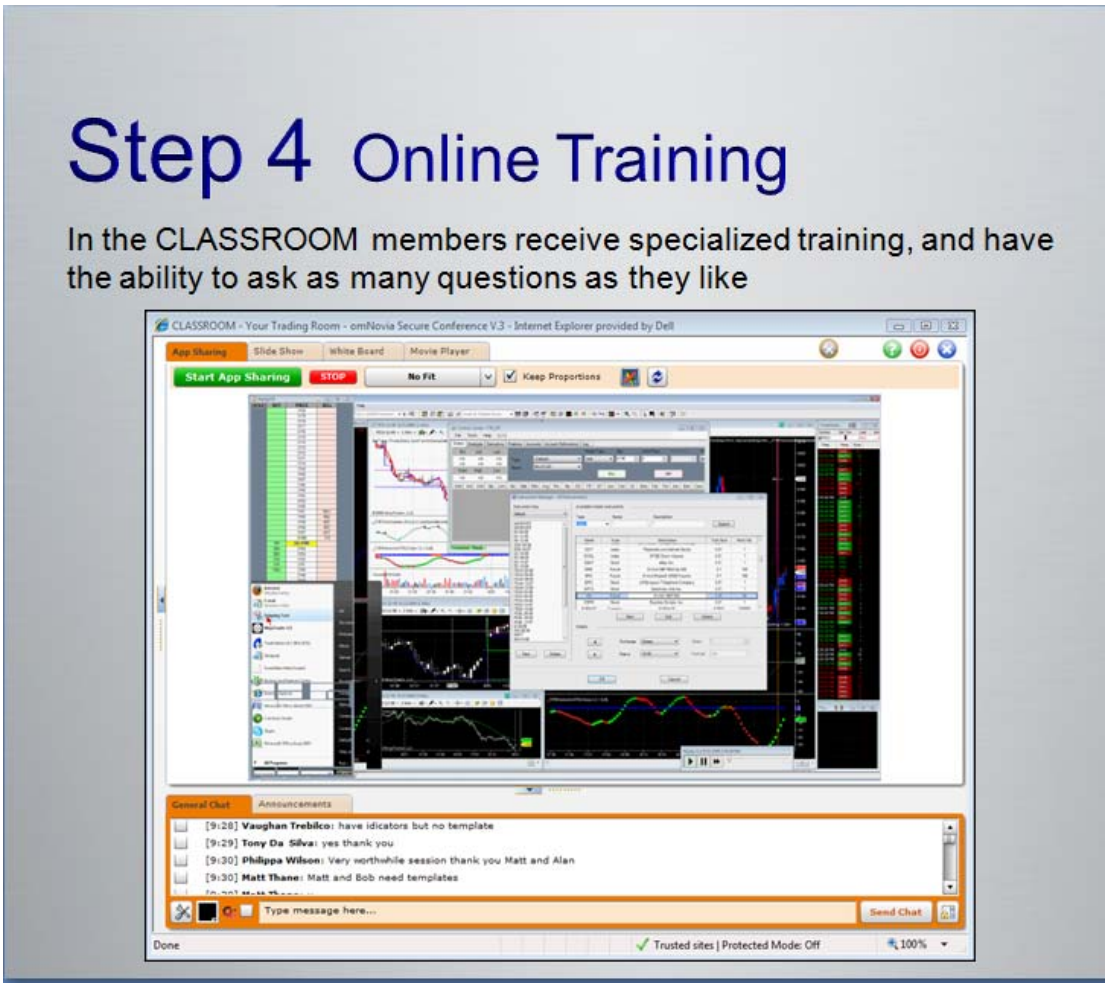
Step 4 Online Training
In the CLASSROOM members receive specialized training, and have the ability to ask as many questions as they like
CLASSROOM - Your Trading Room - omNovia Secure Conference V.3 - Internet Explorer provided by Dell
App Sharing
Slide Show
White Board
Movie Player
Start App Sharing
STOP
No Fit
Keep Proportions
General Chat
Announcements
[9:28] Vaughan Trebilco: have idicators but no template
[9:29] Tony Da Silva: yes thank you
[9:30] Philippa Wilson: Very worthwhile session thank you Matt and Alan
[9:30] Matt Thane: Matt and Bob need templates
Type message here...
Send Chat
Done
Trusted sites | Protected Mode: Off
100%

Participate in our specialised online training, and don't be afraid to ask questions!

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Download the specialized YTR indicators from our website.

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Log in to the trading room of your choice, and join the happy crowd.

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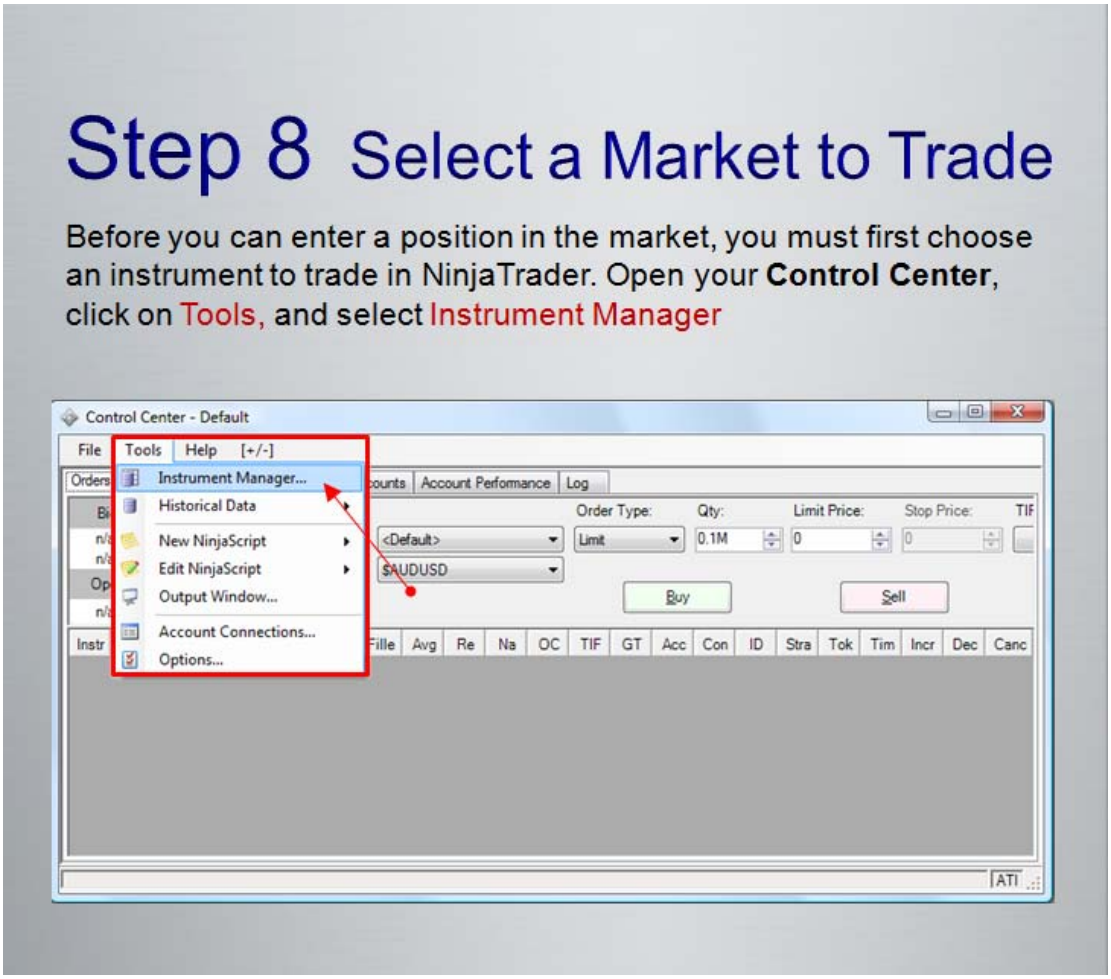
Open a broker account – we recommend two to choose from.



Select a market in which to trade.

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Good luck and happy trading!

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Your Trading Coach concludes:

"Today I stand at the beginning of a grand adventure, with the very real and present opportunity to shape this year into the best one ever. I begin now, take the initiative and never stop living life according to who I know I am."

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